Corporations and Markets Advisory Committee

Insider Trading
Proposals Paper

September 2002

Functions of the Advisory Committee

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

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

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

Members of the Advisory Committee

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

The members during preparation of this Proposals Paper were:

- Richard St John (Convenor)—Secretary, HIH Royal Commission, Sydney
- Susan Doyle—Consultant, Sydney
- Merran Kelsall—Company Director, Melbourne
- David Knott—Chairman, Australian Securities and Investments Commission
- Louise McBride—Partner, Deloitte Touche Tohmatsu, Sydney
- Marian Micalizzi—Chartered Accountant, FCA, Brisbane
- Robert Seidler—Partner, The Seidler Law Firm, Sydney
- Nerolie Withnall—Consultant, Minter Ellison, Brisbane.

Members of the Legal Committee

The members of the Legal Committee are selected by the Minister in their personal capacity from throughout Australia on the basis of their expertise and experience in corporate law.

The members during preparation of this Proposals Paper were:

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

Executive

The members of the Executive involved in preparing this Proposals Paper were:

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

Contents

Introduction

The current review

0.1 The Advisory Committee is currently reviewing Australia's insider trading laws.

0.2 In undertaking this review, the Advisory Committee saw the need for clear and effective laws to protect and guide Australian financial markets. Lack of clarity can result in reduced compliance as well as unproductive uncertainty for market participants. Where necessary, insider trading laws should be strengthened to make them fully effective and assist enforcement. These laws should also not impede legitimate market activity.

Earlier Discussion Paper

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

Legislative developments

0.4 The ambit of the insider trading laws has been considerably extended since the Discussion Paper was published in June 2001. In March 2002, the Financial Services Reform Act (FSRA) introduced amendments into the Corporations Act to harmonise the regulation of financial markets and services. These amendments included extending the insider trading laws beyond securities (including a limited class of over-the-counter-traded securities) and some futures contracts to a very broad range of financial products, including all derivatives, as well as any other financial products that can be traded on a financial market.

Proposals Paper

0.5 This Proposals Paper discusses the implications of the above developments, as well as the Advisory Committee's current thinking on the other matters raised in the Discussion Paper. Before settling its Final Report, the Advisory Committee takes the opportunity to outline, and seek comments on, important issues that have arisen in the review. The Paper is structured as follows.

Chapter 1

0.6 This chapter outlines the key characteristics of the various financial markets that operate in Australia and the implications of the current insider trading laws for each of these markets. It raises for consideration various options on how best to apply the insider trading laws to each of those markets.

Chapter 2

0.7 This chapter discusses the merits of introducing various statutory exemptions, independently of the matters discussed in Chapter 1, in areas where the application of the insider trading laws may be inappropriate. Areas discussed include share issues, buy-backs, off-market transactions in exchange-tradeable securities and transactions in unlisted entities.

Chapter 3

0.8 This chapter summarises the Advisory Committee's current thinking on other matters raised in the Discussion Paper that may require legislative change. These include strengthening the reporting requirements for directors, amending the test of generally available information and introducing rebuttable presumptions that would apply to senior corporate officers.

Chapter 4

0.9 This chapter deals with matters raised in the Discussion Paper that the Committee considers should not be changed. These include retaining the existing law that applies to anyone with inside information, whether or not connected with the affected company, and confirming that informed persons are liable, whether or not they use the information to trade.

Request for comments

0.10 In formulating this Paper, the Advisory Committee has very carefully considered the Submissions on the Discussion Paper. The Committee now invites comments on any matter raised in this Proposals Paper or any other matter relevant to insider trading. All Submissions and comments will be acknowledged in the Final Report.

0.11 Please send your comments to:

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by any of the following means:

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0.12 If you are sending your comments otherwise than by Email, please also send, if possible, a computer disk containing your submission, using Microsoft Word for Windows 2000.

0.13 If you have any queries, please phone (02) 9911 2950.

Closing date for comments

0.14 Please forward your comments by **Friday 1 November 2002**.

Further copies

0.15 This Proposals Paper is available under What's New on the Advisory Committee's Website **www.camac.gov.au**.

1 Financial market transactions

Current law

1.1 The laws prohibiting insider trading in Australia are very broad in their application. Part 7.10 Division 3 of the Corporations Act prohibits any person aware of 'inside information' from trading, disclosing or procuring in relation to relevant financial products, subject to various exceptions and defences. Inside information is defined under s 1042A of the Corporations Act as any information that:

> is not generally available [but], if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products.

1.2 'Division 3 financial products' are:

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

1.3 These laws, which reflect the amendments introduced in March 2002 to harmonise the regulation of the Australian financial system, apply to all these financial products, whether traded on-exchange, over-the-counter (OTC) or through off-market principal-to-principal contracts.

Fair and efficient financial markets

1.4 Breach of the insider trading laws is a serious criminal offence, carrying a maximum penalty of 5 years imprisonment, as well as substantial fines. There are also significant civil consequences, such as disgorging any profits made or losses avoided in the transactions and prohibiting an offender from acting as a company director or otherwise managing a corporation.

1.5 The justification for prohibiting insider trading, with criminal and civil consequences of this nature, is that it is required to ensure the fairness and efficiency of financial markets. In general terms, a market is fair if it operates in a manner that is equitable to the participants, according to the reasonable expectations of equity in that market. Likewise, a market is efficient if it operates in the manner best suited to facilitating transactions, without undue costs, delays or other disincentives to participation.

1.6 What is necessary to achieve fairness and efficiency in each market depends on the fundamental features and economic role of that market and the reasonable expectations of its participants.

1.7 Another key factor in assessing the suitability of insider trading laws for particular financial markets is their impact on competitive neutrality between markets. The *Financial System Inquiry Final Report* (March 1997) (the Wallis Report) emphasised that laws should not advantage one market over another, or discriminate between markets, except where there is an overriding public interest. The Advisory Committee strongly supported competitive neutrality in its Report *Regulation of On-exchange and OTC Derivatives Markets* (June 1997).

1.8 Competitive neutrality is often achieved by harmonising the regulation of different financial markets with similar economic functions. However, account must also be taken of the essential differences between these markets. Regulation needs to ensure that it accommodates the diversity of financial markets, while promoting fairness and efficiency in each market.

Summary of the policy options

1.9 The Advisory Committee Discussion Paper, which foreshadowed the March 2002 amendments, raised a series of questions concerning the application of the insider trading provisions to different financial markets in Australia.

1.10 In light of the Submissions received, and the Advisory Committee's further deliberations, the Committee raises for debate the merits of adjusting the insider trading laws to particular financial markets.

1.11 Other possible reforms, which are independent of this issue, are discussed in Chapters 2–4.

Stock exchanges

1.12 Should the insider trading laws for transactions on the ASX and other stock exchanges:

- be amended by adding a disclosable information element, namely that 'the information must relate to matters that a regular user would reasonably expect to be disclosed to other users of the market on an equal basis, whether at the time in question or in the future', or
- be amended in some other way to take account of the features of these markets, or
- not be amended for this purpose.

Sydney Futures Exchange

1.13 Should the insider trading laws for transactions on the SFE:

- be limited to products that were regulated under the pre-March 2002 legislation, or
- incorporate the disclosable information element, or

- be amended in some other way to take account of the features of this market, or
- not be amended for this purpose.

Over-the-counter (OTC) markets

1.14 Should the insider trading laws for OTC transactions:

- be repealed, or
- be confined to 'linked' products, or
- incorporate the disclosable information element, or
- be amended in some other way to take account of the features of these markets, or
- not be amended for this purpose.

Exempt markets

1.15 Should the insider trading laws for transactions on exempt markets:

- incorporate the disclosable information element, or
- adopt some other approach to take account of the features of these markets, or
- not be amended for this purpose.

New markets

1.16 Should the insider trading laws for transactions on new markets:

- incorporate the disclosable information element, or
- adopt some other approach to take account of the features of these markets, or
- not be amended for this purpose.

Stock exchanges

Nature of these markets

1.17 The Australian Stock Exchange (ASX) is the principal, though not the only, stock exchange in Australia. For convenience, this Proposals Paper will henceforth refer only to the ASX.

1.18 The ASX is an 'anonymous market' in that the identity of a participant, whether or not known to the counterparty, is irrelevant to each participant's contractual rights, which are guaranteed through the clearing house. All on-exchange transactions, as well as crossings and special crossings, fall within the anonymous ASX market concept, as the contractual rights of the parties are guaranteed by the clearing house.

Ensuring fairness and efficiency through disclosure

1.19 The continuing fairness and efficiency of the ASX market depend fundamentally on arrangements by which certain information relevant to the pricing of securities must be disclosed to market participants on an equal basis or else is customarily made known by public announcement (for instance, by monetary authorities). Central to these arrangements are the continuous disclosure standards that apply to this market (under Chapter 6CA of the Corporations Act and ASX Listing Rule 3.1) and which are central to its pricing mechanism. The ASX administers this continuous disclosure regime, which requires a listed entity to immediately disclose to the Exchange any information of which it is aware and which a reasonable person would expect to have a material effect on the price or value of its securities, subject to various exemptions (carve-outs). The ASX has a publicly accessible announcement facility for immediately disseminating this information. There are additional requirements for periodic reports, which are also publicly accessible.

1.20 The effect of these disclosure requirements is that all ASX market participants are entitled to expect that the prices at which financial products are traded on that Exchange properly and promptly reflect all information coming within its disclosure regime, other than information legitimately withheld under the disclosure carve-outs.

Policy options

1.21 The insider trading laws generally apply to any person who is aware of any materially price-sensitive information that is not generally available or known to the counterparty. The Advisory Committee raises for consideration whether:

- this formulation should remain, or
- an additional disclosable information element should be added, or
- some other change should be introduced.

The possible benefits and consequences of the disclosable information element are discussed below.

Disclosable information element

1.22 The insider trading laws could be more directly linked to the current stock exchange disclosure standards by requiring that, in addition to information being materially price-sensitive and not generally available:

> The information must relate to matters that a regular user would reasonably expect to be disclosed to other users of the market on an equal basis, whether at the time in question or in the future [disclosable information element].

1.23 This concept, based on the UK Financial Services Authority Code of Market Conduct, could be an element of the offence or, alternatively, be included as a defence.[1]

1.24 Disclosable information would include:

- *continuous disclosure information:* all information coming within the continuous disclosure requirements, including information that will have to be disclosed 'in the future' under those requirements, even though the information is lawfully withheld from immediate publication under a carve-out. Only information that is intended to be perpetually excluded from disclosure, such as trade secrets, would be exempt, as there is no market expectation that information of that kind should be disclosed

- *reportable information:* all information about market transactions that, either now or in the future, must be disclosed to the market either under the Corporations Act or ASX Rules. This would include information about any transactions coming within the substantial shareholding requirements of Part 6C.1 of the Corporations Act or transactions to be disclosed under the ASX Business Rules. Assume, for instance, that a person learns that someone intends to transact, or has transacted, in securities of a listed entity. That information would be disclosable information if the transaction will have to be disclosed 'in the future' under either the substantial shareholding or business rule requirements

- *announceable information:* any information that is routinely the subject of a public announcement, though not subject to any formal disclosure requirement, such as public announcements by governments, monetary or fiscal authorities or regulatory bodies, changes to published credit ratings of listed companies or changes to constituents of a securities index.

1.25 The disclosable information element focuses on the nature of the information, not the identity of the holder. It would apply whether or not the holder had a disclosure obligation. This can be seen from the following example. An employee of a printery learns the identity of the intended target of a still-confidential takeover bid by examining the takeover documents being printed and trades on-market before the market becomes aware of the bid. The employee himself has no obligation to disclose that information, but clearly it satisfies the disclosable information element, being information that the market would expect to be disclosed in the future (that is, when the bid is announced).

Establishing the disclosable information element

1.26 To prove that any information in question is disclosable information may require expert evidence. However, proof that information is price-sensitive (an essential element of any insider trading laws) can also be used to satisfy the disclosable information element.

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[1] The UK Code of Market Conduct, which contains the disclosable information element, applies only to administrative remedies enforced by the FSA for trading in particular prescribed markets. It does not replace the UK criminal provisions, which, like the current Australian provisions, have the price-sensitivity element, but not the disclosable information element. However, the UK criminal provisions are in other respects significantly narrower than the Australian law in that they:
- limit the legislation to trading on regulated markets or where the persons dealing rely on a professional intermediary or are themselves acting as professional intermediaries
- adopt a 'person connection' test in addition to the 'information connection' test. The Advisory Committee does not support any additional 'person connection' test for Australia (see paras 4.6–4.9).

1.27 For instance, all information falling within ASX Listing Rule 3.1, other than perpetual carve-outs, would be disclosable information, as the market would expect that information to be publicly disclosed. That Listing Rule requires the disclosure of any information known to and concerning an entity that 'a reasonable person would expect to have a material effect on the price or value of the entity's securities'. Therefore, proof that the information was materially price-sensitive and therefore subject to the Listing Rule would also prove that it was disclosable information.

Implications for ASX market integrity

1.28 Insider trading legislation that includes the disclosable information element would promote market fairness, as well as support the continuous disclosure regime. It would reinforce the expectation of market participants that they have an equal level of access to disclosable information (notwithstanding any differences in their willingness to acquaint themselves with that information or their ability to analyse its market price implications). The insider trading laws would prohibit persons from trading in affected financial products when aware of any price-sensitive information that should be, but has not yet been, made available to other market participants on an equal basis.

Overcoming the possible overreach of the existing law

Research

1.29 Research undertaken by participants in financial markets can be a key factor in improving the pricing efficiency of those markets. The insider trading laws should not discourage legitimate research.

1.30 The disclosable information element would help overcome uncertainty about when information gathered through private research constitutes inside information. Currently, all price-sensitive information so gathered is inside information, unless it consists exclusively of deductions, conclusions or inferences made or drawn from generally available information. The disclosable information element would exclude private research from the definition of inside information, except for matters that the market would expect to be publicly disclosed, now or in the future (for instance, information about the financial position of a listed company obtained from a senior corporate officer before its publication).

Advice to clients

1.31 Including the disclosable information element would overcome the possible problem under the current law that clients who trade after receiving analysis or advice from their brokers or financial advisers may technically breach the insider trading provisions if that analysis or advice is sufficiently influential that it could have a material effect on the price or value of particular financial products, if generally available. In these circumstances, the broker or adviser could also be technically liable for tipping.

Perpetual carve-outs

1.32 Persons may hold information, such as trade secrets, that, while never intended to be disclosed, could nevertheless constitute inside information under the current definition as, 'if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3

financial products'. These persons could therefore never trade in affected financial products, even though the information never comes into the public arena and therefore would not change the price of the financial products. The disclosable information element would overcome this problem by being confined to information that other market users would expect to be disclosed either now or 'in the future'.

Rumour or speculation

1.33 Another consequence of the disclosable information element would be to reduce uncertainty about when persons may lawfully trade in response to price-sensitive rumour or speculation. The current definition of inside information includes any matters of supposition that may materially affect the price or market value of particular financial products, whether in fact true or not. Recipients of rumours or speculation may breach the current insider trading prohibition by trading in affected securities, unless the rumour or speculation is sufficiently widespread that it is 'generally available' or is sufficiently disbelieved that it is not price-sensitive. The disclosable information element would confine the insider trading laws to information that the market would expect to be disclosed.

Implications for broker-client relationships

1.34 Some broker-client communications would still come within the insider trading laws. Assume, for instance, that a client informs a broker of his still-confidential intention to make a takeover bid. That broker would breach the insider trading laws by trading in affected securities before the market became aware of that intention, as that intention (unlike standard transaction instructions from a client to a broker) would be information that the market would expect to be disclosed, in the future at least, under the disclosable information test.

1.35 However, an incidental effect of the disclosable information element would be that frontrunning (that is, brokers transacting on their own behalf before implementing their clients' instructions), scalping (that is, trading in advance of conveying trading recommendations to clients) and piggybacking (that is, transacting with knowledge of a client's trading strategy and before receiving specific instructions based on that strategy) would, in most instances, no longer come within the insider trading provisions. These transactions may well breach the fiduciary obligations owed by brokers to their clients, but the market generally would not expect communications between brokers and clients to be publicly disclosed, now or in the future.

1.36 Frontrunning is prohibited under s 991B (brokers to give priority to clients' orders). Scalping and piggybacking, as well as frontrunning, may be caught under s 991A (brokers not to engage in unconscionable conduct). However, the maximum penalties for breach of s 991B ($2,750 or imprisonment for 6 months, or both) are much less than for insider trading ($222,000 or imprisonment for 5 years, or both), while s 991A provides only a civil remedy. Brokers also have disclosure obligations under Part 7.7 of the Corporations Act, including any conflicts of interest.

1.37 If the disclosable information element is adopted, these provisions should be reviewed to ensure that they clearly and comprehensively deal with frontrunning etc, taking into account that this behaviour can damage the market, as well as breach the broker-client relationship. For instance, frontrunning could potentially disadvantage a counterparty who dealt with a broker rather than the broker's client, for instance, a shareholder selling to the broker at a price lower than the potential market price if the client's substantial buy order had been executed first.

1.38 Scalping could be prohibited outright or where brokers fail to disclose at the time of conveying their recommendations to clients that they have already traded in the recommended financial products.

1.39 A related question is whether persons other than brokers or financial services advisers who trade in advance of conveying their trading recommendations to others should be subject to frontrunning controls. An example would be an influential journalist trading in advance of publishing a materially price-sensitive recommendation in a newspaper column.

Simplify the test of when information is generally available

1.40 The disclosable information concept may eliminate the need for the readily observable matter (ROM) test of when information is generally available. The ROM test, as explained in paras 2.8 ff of the Discussion Paper, was introduced late in the legislative process that led to the 1991 insider trading amendments, apparently to meet concerns about the potential breadth and open-ended nature of the definition of inside information. The disclosable information concept reduces the ambit of this definition by excluding information that, even though price-sensitive, is not the type of information that the market expects to be publicly disclosed.

1.41 In consequence, the 'excess stocks in the yard' example used in the Explanatory Memorandum to justify the ROM test would not be disclosable information, as it would not be information that regular users of a market would expect to be publicly disclosed. The test of when information is generally available could therefore be confined to the current publishable information test, as described in paras 2.3 ff of the Discussion Paper.

Sydney Futures Exchange

Nature of this market

1.42 The Sydney Futures Exchange (SFE), like the ASX, is an anonymous market, in that the identity of a participant, whether or not known to the counterparty, is irrelevant to each participant's contractual rights, which are guaranteed through the clearing house. Also, like the ASX, SFE-traded products are standardised or fungible, unlike customised products traded OTC.

Pre- and post-March 2002 laws

1.43 Prior to the commencement of the Financial Services Reform Act (FSRA) in March 2002, the insider trading laws applied only to those futures contracts that related to the securities of a body corporate or the price of those securities, such as individual share and share index futures (equity-linked products). The FSRA amendments extended the insider trading laws to all transactions on the SFE, including interest rate, currency and commodity products, as well as equity derivatives.

Policy Options

1.44 The Advisory Committee raises for consideration whether the current insider trading laws for SFE-traded products should:

- remain unchanged, or
- be limited to those products regulated under the pre-March 2002 legislation, or
- be limited by including the disclosable information element, or
- be limited in some other way.

The merits of the second and third policy options are discussed below.

Pre-March 2002 regulated products

1.45 The apparent purpose of the pre-March 2002 insider trading legislation, as it applied to securities-linked futures contracts, was to support the prohibition on insider trading in equities. For instance, persons who were prohibited from trading in particular securities on the ASX could not lawfully trade in related equity-linked products on the SFE. That legislation did not extend to other products traded on the SFE.

1.46 This pre-March 2002 policy could be restored by limiting the insider trading laws to equity-linked SFE products, with those products being subject to the same insider trading laws as apply to transactions on the ASX. If the disclosable information element is applied to ASX trading, the same element should apply to trading on the SFE in equity-linked products. The test of what is disclosable information for these SFE products would be any information that a regular ASX user would reasonably expect to be disclosed to other ASX market users on an equal basis. The ASX disclosure standards would be appropriate, as they directly affect the pricing of equity-linked products on the SFE. This approach would support the prohibition on insider trading of those underlying securities.

1.47 The insider trading laws would not apply to transactions in non-equity products, such as derivatives over commodities. Commodity producers may, for sound prudential reasons, wish to adopt hedging strategies using commodity derivatives. Arguably, it may be undesirable to prevent them from so doing whenever they have any non-public information about the commodity that may be price-sensitive in the derivatives market. The possibility raised in the Discussion Paper of allowing commodity producers to hedge their physical positions but prohibiting them from over-hedging or profit-taking may be unworkable. Hedging strategies are often complex and involve a range of different derivatives that cannot be precisely matched against physical positions, even where the primary aim is to hedge underlying exposures in the physical market.

Disclosable information element

1.48 Under this policy option, equity-linked products traded on the SFE would be subject to the disclosure standards on the ASX.

1.49 In relation to other products traded on the SFE, that Exchange does not have a disclosure regime similar to that of the ASX. However, the concept of disclosable information would apply in some instances.

- Some industry-specific legislation imposes disclosure obligations that can affect some SFE-traded products. Electricity generators, for instance, have a statutory obligation to keep the market continuously informed about plant availability. This information is relevant to any SFE market in electricity hedges.

- Persons may be aware of announceable information that is not yet publicly disclosed, for instance, a decision by a monetary authority on interest rates or a government decision affecting its bond market. In these instances, an informed person who traded in a related SFE product before the information was generally available would be subject to the insider trading laws.

1.50 Under this policy option, the insider trading laws would not apply where a person has price-sensitive information affecting an SFE-traded product but there is no requirement or expectation that this information be disclosed to the market generally.

OTC financial markets

Nature of OTC financial markets

1.51 Australian OTC financial markets (OTC markets) are markets in a commercial, but not generally in a legal, sense, as they tend to lack a centralised market facility (as required under the definition of financial markets in s 767A). Instead, they generally comprise privately negotiated bilateral contracts, with many participants in the market being licensed financial service providers.

1.52 Products traded OTC include cash loans, reciprocal purchase agreements (repos), negotiable instruments, forward rate agreements, interest rate swaps and options, foreign exchange, electricity contracts, debt securities and credit, commodity and equity derivatives.

Risk transfer role of OTC financial markets

1.53 A key role of OTC markets, against which fairness and efficiency should be assessed, is risk transfer. Many of the traded products are designed primarily for transfer of financial, commercial or production risks. It is accepted practice that a party to an OTC risk transfer contract may have information that could materially affect the value of that contract and which is unknown to the counterparty or to the market generally. It is for the parties, when negotiating the terms of that contract, to determine the type and level of disclosure between them.

1.54 An example of a risk transfer contract is a credit derivative, such as a credit default swap, whereby a party (the protection seller) receives a fixed rate payment from a bank (the protection buyer) in return for undertaking the default risks on a defined part of the bank's loan portfolio. Protection sellers are invariably sophisticated domestic or international institutions. The terms and conditions of credit derivatives are strictly contractual, with the parties determining the level and type of disclosure required under the contract.

1.55 Another example is an electricity swap, designed to allow participants in the national electricity market, such as electricity generators and electricity retailers (who purchase electricity and on-sell it or supply it to end-users), to hedge against the financial risks involved in changes to the level of electricity generation or demand by consumers.

Contrast with Exchange markets

1.56 Unlike anonymous Exchange markets, OTC markets are 'personalised markets' in which participants contract principal-to-principal, with each party bearing the risk that the counterparty will default, in whole or part, on its financial obligations under the contract (counterparty credit risk). There is no statutory prohibition on retail participation in OTC markets. However, unlike Exchange markets, there is little practical opportunity for direct retail participation in OTC markets, given the financial requirements for satisfying counterparty credit risk and that the typical monetary size of even minimal OTC transactions is multiple millions of dollars.

1.57 The terms and prices of OTC transactions can be tailored through bilateral negotiation, in contrast to standardised or fungible products traded on-exchange. There is an expectation that parties can protect themselves against information asymmetry by negotiating disclosure covenants and warranties. In addition, parties can rely on statutory, and common law, protections against any misrepresentation or false or misleading statement by a counterparty.

1.58 There is generally no expectation or procedure in OTC markets for the centralised disclosure or dissemination of price-sensitive information in the same manner as in the ASX market. In only some circumstances, such as under the limited disclosure obligations in the electricity market or announcements by monetary authorities on interest rates, would OTC market participants reasonably expect information to be made available simultaneously to the market generally.

1.59 OTC markets, unlike the ASX, generally do not have any centralised price-recording and price-setting mechanism. Instead, OTC markets tend to advertise only bids and offers, not traded prices. It is also accepted that the terms, and prices, of some bilaterally negotiated OTC contracts may never be disclosed.

Insider trading laws prior to March 2002

1.60 A limited range of OTC equity-based products, including government bonds, were subject to the pre-March 2002 insider trading laws. However, most OTC products, including repos and credit, interest rate, currency, electricity and commodity derivatives, were not subject to those laws.

1.61 The March 2002 amendments extended the insider trading provisions to all OTC products, primarily by including derivatives. These amendments were foreshadowed in earlier Corporate Law Economic Reform Program (CLERP) documents. However, whether, or in what circumstances, insider trading laws were necessary to support fair and efficient OTC markets was never publicly debated. There was no discernible call from OTC participants to have the insider trading laws apply generally to OTC markets, nor did OTC participants argue that these laws were necessary to support their confidence in these markets.

1.62 The March 2002 amendments to the insider trading provisions primarily reflected the harmonisation objectives of the Financial Services Reform Act to apply uniform laws to financial products.

Overreach of the current law

1.63 Arguably, the application of the existing insider trading laws to OTC markets has the potential to interfere fundamentally with the risk transfer functions of those markets and the enforceability of private bilaterally negotiated contracts.

- It prohibits anyone with confidential information that can materially affect the value of an OTC financial product (inside information) from entering into an OTC transaction in that product with an uninformed counterparty. It may be impractical and contrary to the reasonable expectations of OTC market participants to expect each participant to determine whether the counterparty is, or should be, aware of all price-sensitive information known to that participant and, if not, to disclose that information or abstain from trading. Likewise, it would appear contrary to the risk-hedging functions of credit derivatives, to require banks to provide counterparties with all relevant information that could affect the price or value of the derivative contract. Also, in some instances, a contracting party may be under a duty not to disclose price-sensitive information, or could suffer significant commercial detriment from disclosure.

- It may impede market participants who become aware of inside information from carrying out, or continuing with, portfolio management activities such as hedging or closing out open positions in affected OTC products, notwithstanding that these transactions may be essential for proper ongoing risk management and compliance with accepted prudential standards.

- It may encourage a counterparty to initiate civil litigation under the insider trading provisions merely to delay payment of an OTC contract or to seek an out-of-court renegotiation of its terms or price.

1.64 Insider trading laws may also reduce the efficiency of OTC markets by materially increasing participants' compliance costs and legal uncertainty about the possible criminal and civil consequences of entering into particular OTC transactions.

1.65 Australian OTC markets represent only a small percentage of the world's OTC markets. Having insider trading laws in Australian, but not comparable overseas, OTC markets may create strong disincentives for local and overseas participants to trade on the Australian markets. Participants may prefer to trade overseas to avoid the compliance costs, legal uncertainties and possible criminal liability of trading in Australia. Over time, this may seriously reduce the competitiveness of Australian OTC markets.

Chinese Walls defence

1.66 There is a question whether the Chinese Walls defence is appropriate or workable for OTC market participants, particularly for information generated within these entities that could materially affect the value of the OTC product. Take, for instance, a bank entering into a credit derivative. That decision may stem from the bank's own confidential price-sensitive internal risk ratings and other credit information about clients. It would be impractical, and contrary to the risk transfer purpose of entering into credit derivative contracts, to isolate the bank's decision makers from this information.

1.67 Another example of the impracticality of a Chinese Wall would be electricity generators or retailers entering into electricity derivative hedging contracts. These

parties may often have internal price-sensitive information about their own electricity generation or level of consumer demand. Their decision makers would need to be aware of all information about their exposure to the physical electricity market in determining whether they should enter into derivative hedging contracts. Isolating the decision makers from this information may increase, rather than reduce, their commercial risks or result in them entering into inappropriate derivatives contacts.

Policy Options

1.68 The Advisory Committee raises for consideration whether the current insider trading laws for OTC-traded financial products should:

- remain unchanged, or
- be repealed, or
- be limited to 'linked' products, or
- be limited to disclosable information, or
- be changed in some other manner.

The merits of the second, third and fourth policy options are discussed below.

Exempt all OTC transactions from the insider trading laws

1.69 This policy option would exclude all OTC market trading from the insider trading provisions, with market participants being able to protect their own interests through bilateral negotiation. Arguably, this approach is more cost-effective, less intrusive and more consistent with OTC market practices and expectations than reliance on an external insider trading regime.

1.70 The exemption would only apply to the OTC transactions themselves. The occurrence of some OTC equity transactions, for instance, may constitute inside information for subsequent related equity transactions on the ASX or SFE that are subject to the insider trading laws.

1.71 One consequence of a total exemption would be to permit informed persons to trade OTC notwithstanding that they are prohibited from trading in comparable products on an Exchange (market arbitrage). For instance, an informed person who was prohibited from lawfully trading in particular securities on the ASX could nevertheless trade in derivatives of those exchange products, such as equity swaps, on an OTC market.

1.72 Market arbitrage is a matter of concern only if it is detrimental to a fair and efficient Exchange or OTC market. Even then, the possibility of market arbitrage may not of itself justify imposing insider trading laws on all OTC transactions, given that:

- these transactions tend to be very large, the average minimum being multiple millions of dollars, thereby precluding anyone from engaging in market arbitrage in relatively small amounts. As a practical matter, the considerable size of even minimum OTC transactions, as well as the financial requirements for counterparty credit risk, may deny many informed persons any realistic opportunity to engage in market arbitrage on OTC markets

- OTC counterparties can request information, or require disclosure warranties, before transacting. Informed persons who breached those disclosure requirements could be liable for providing false or misleading information, as well as having their contractual rights curtailed through action for breach of contract.

1.73 Also, the compliance costs and legal uncertainty that may arise from applying the insider trading laws to all OTC transactions to avoid any possible market arbitrage could outweigh any benefits to be gained from this approach.

Limit insider trading laws to linked products

1.74 This policy option would apply the insider trading laws only to those OTC derivatives of products that can be traded on an Exchange or other licensed market. [It would also need to be made clear that the disclosable information element, if included in the definition of inside information, would apply to the expectations on the Exchange or other licensed market, not on the OTC market. In relation to para 1.75, there are different disclosure expectations, even on an Exchange market, depending on the type of product traded. For instance, the disclosure expectations for currency products are much less than for equities. Therefore, is para 1.75 really a problem?] This approach is adopted in the UK.

1.75 This policy option would prohibit Exchange-linked market arbitrage. However, the reach of the insider trading laws in OTC markets would depend on the types of products traded on an Exchange or other licensed market from time to time. In consequence, the existence of innovative, or even thinly traded, products on an Exchange market could result in the insider trading laws applying to a very broad range of related products on an OTC market. For instance, the offering of any currency products on an Exchange would have the effect of extending the insider trading regime to all OTC currency derivatives.

1.76 One possible response would be to apply the insider trading laws only to those OTC products where the level of trading of the on-exchange product reaches a minimum threshold proportion of the level of OTC trading in related products. However, this could create uncertainty about what OTC products are subject to insider trading regulation from time to time, in the absence of some prescription.

1.77 The UK Code of Market Conduct reduces the impact of extending its insider trading regulation to linked products by including various defences, for instance, that a person's possession of inside information did not influence that person's decision to engage in trading, that is, the person did not use the information for the purposes of trading (UK Code of Market Conduct para 1.4.21). For the reasons given elsewhere in this Proposals Paper (paras 4.23–4.28), the Advisory Committee does not support any use requirement or defence of non-use.

Note: the Report should make clear that for linked products the disclosure expectation, under a disclosable information test, is that of the highest in any linked market, typically the ASX. Thus, for an equity derivative, the disclosable information test would apply the disclosure expectations of the ASX market, not the OTC market.

Limit insider trading laws to disclosable information

1.78 This policy option would apply the insider trading laws, with the disclosable information element, to OTC markets. The effect of this approach would depend on the disclosure expectations of OTC market participants generally, taking into account that

OTC markets do not operate under continuous disclosure rules or centralised market disclosure and price-setting mechanisms.

1.79 An example might be a person who, say, trades in OTC interest rate swaps when aware of a yet-to-be-announced official decision to alter official interest rates that differs from market expectations. Arguably, market participants would expect all these decisions to be made generally available through a public announcement.

1.80 Some problems could arise in applying the disclosable information element to OTC products.

- Except in very limited circumstances (such as the interest rate example or the statutory disclosure obligations for entities generating electricity), there are currently no clear standards for determining what, if any, information should be publicly disclosed to OTC market participants, nor is there any identifiable platform for its dissemination.
- There may be an element of uncertainty about how the law would apply in particular circumstances. This could increase the compliance costs and legal uncertainty of transacting OTC.
- Regulators may have difficulty in any enforcement proceedings in establishing disclosure standards in an OTC market, which may require expert evidence to be led in each case.

1.81 This raises the question whether any proposal to introduce the disclosable information element for OTC markets would need to be supported by formal disclosure guidelines and procedures. In the UK, entities can approach the Financial Services Authority to obtain a ruling on what constitutes disclosable information.

Exempt markets

1.82 Over a period of years, several markets, including markets for interests in various property syndicates, have been granted exemptions from the licensing requirements for financial markets. Some of these markets may eventually become licensed markets or continue to be exempted (under s 791C). Also, some new markets may seek to become exempt markets.

1.83 Each exempt market has been established by a separate exempt market declaration and has its own rules, including disclosure requirements. Many of these markets allow trading in only a single type of securities. Some, but not all, of these markets are confined to wholesale participants. These markets do not usually have a clearing facility and trading on them is not necessarily anonymous.

1.84 The application of the insider trading laws to particular exempt markets would depend on the general policy approach to regulating markets and the characteristics of each exempt market. For instance, insider trading laws that included a disclosable information element in the definition of inside information would apply to the extent that the exempt markets have disclosure requirements or expectations.

Emerging markets

1.85 New or alternative financial markets may emerge in the future, offering new products or replicating products already traded on established financial markets.

1.86 The application of the insider trading laws to any new financial market would depend on the general policy approach to regulating markets and the characteristics of the particular new market. For instance, uniform insider trading laws that included a disclosable information element in the definition of inside information would apply to the extent that there are disclosure requirements or expectations in that market.

2 Possible carve-outs

Overview

2.1 In this chapter, the Advisory Committee reviews the merits of introducing exemptions, under either the current or market-adjusted insider trading laws (as discussed in Chapter 1), for:

- an entity making a general issue
- an entity making an individual placement
- buy-backs
- private transactions in exchange-tradeable financial products
- transactions under non-discretionary trading plans
- transactions in unlisted entities.

Entity making a general issue

[Discussion Paper paras 2.99–2.106]

Current disclosure laws

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

2.3 There is a range of criminal and civil liabilities under Part 6D.3 for breach of the fundraising provisions, including for any misstatements in, or omissions from, the disclosure document. Also, action may be taken against the issuer under s 1041E of the Corporations Act for any false or misleading statements likely to induce persons to subscribe for securities.

Current insider trading laws

Issuers

2.4 *Exicom Ltd v Futuris* (1995) 18 ACSR 404 has been treated as authority for the proposition that the insider trading provisions do not apply to an issuer of new

securities (though the case involved a private placement rather than a public issue and some of the reasoning in the case is questionable).

Offerees

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

Rationale for continuing to include issuers in the insider trading regime

2.6 Some respondents to the Discussion Paper argued that the insider trading provisions should continue to apply to issuers, to complement the statutory fundraising disclosure obligations. Their view was that the insider trading rules would pose no barrier to a share issue where the issuer has fully complied with the statutory fundraising disclosure obligations.

Rationale for excluding issuers from the insider trading regime

2.7 An argument for excluding share issues from the insider trading regime, supported by a number of respondents to the Discussion Paper, is that the current prospectus and other disclosure requirements for share issues cover the same conduct as insider trading. These disclosure laws should deal comprehensively with this conduct, without relying on the insider trading laws to fill any perceived gaps. If necessary, the criminal and civil penalties and remedies under Part 6D.3 of the Corporations Act should be adjusted to make them comparable to the insider trading penalties and remedies.

Advisory Committee position

Issuers

2.8 The Advisory Committee is giving further consideration to whether issuers should be included in or excluded from the insider trading regime. The Committee welcomes comments.

Offerees

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

Entity making an individual placement

[Discussion Paper paras 2.99–2.106]

2.10 An entity may offer its new securities to individual investors, rather than make a general offer.

Current disclosure laws

2.11 Small offers up to a limited number of investors, and offers through licensees to experienced investors, are exempted under s 708 from the fundraising disclosure requirements in Chapter 6D of the Corporations Act.

Current insider trading laws

Issuers

2.12 *Exicom Ltd v Futuris* held that the insider trading regime does not apply to a company when making an individual placement of its securities.

Placees

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

Arguments for excluding issuers from the insider trading regime

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

2.15 The regulation of individual placements could be left to:

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

2.16 A disclosing entity is also subject to the continuous disclosure requirements.

Arguments for continuing to include issuers in the insider trading regime

2.17 The insider trading rules could make up for any possible deficiencies in the disclosure requirements for individual placements. However, the effect would be that an issuer could never make an individual placement without full disclosure, despite having statutory exemptions from the fundraising disclosure requirements.

Advisory Committee position

Issuers

2.18 The Advisory Committee is giving further consideration to whether issuers should be included in or excluded from the insider trading regime. The Committee welcomes comments.

Placees

2.19 The Advisory Committee considers that placees who accept new securities when aware of inside information not known to the issuer should remain subject to the insider trading laws.

Buy-backs

[Discussion Paper paras 2.107–2.116]

The current buy-back law

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

Current insider trading laws

Buying back entities

2.21 *Exicom Ltd v Futuris* has been treated as authority for the proposition that entities that buy back their own securities are not subject to the insider trading laws, as a company cannot be an insider in relation to its own securities (though this case dealt with a placement, not a buy-back, and some of the reasoning in the case is questionable).

2.22 The Corporations Act s 1043B exempts buy-backs by managed investment schemes from the insider trading provisions, provided the buy-back price is calculated pursuant to the scheme constitution and by reference to the underlying value of the scheme assets, and not unilaterally by any party in possession of any inside information.

Offerees

2.23 The insider trading prohibition applies to any offeree who is aware of confidential price-sensitive information affecting the value of the shares that is unknown to the buying back entity (for instance, a shareholder, but not the company, is aware of confidential, settled negotiations between competitors of the company that will pose a significant threat to the company's market share).

Arguments for excluding buy-back entities from the insider trading regime

2.24 A number of Submissions on the Discussion Paper argued that the Corporations Act Part 2J.1 Div 2 seeks to comprehensively regulate buy-backs. In addition, all listed entities are subject to continuous disclosure requirements. Any perceived shortcomings in the statutory buy-back disclosure requirements, or penalties for breach, could be remedied by appropriate reform of those provisions, without having to rely on the insider trading laws to make up for any identified deficiencies.

Arguments for continuing to include buy-back entities in the insider trading regime

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

Advisory Committee position

Buy-back entities

2.26 The Advisory Committee is giving further consideration to whether buy-back entities should be included in or excluded from the insider trading regime. The Committee welcomes comments.

Offerees

2.27 The Advisory Committee considers that offerees who accept a buy-back offer when aware of inside information not known to the buying-back entity should remain subject to the insider trading laws.

Private transactions in exchange-tradeable financial products

2.28 Private transactions are principal-to-principal transactions effected off-market. They do not include ordinary or special crossings, which are on-market transactions.

Overreach of the existing law

2.29 The current insider trading laws can significantly affect private commercial transactions in financial products of listed entities. For instance, an informed party to a principal-to-principal financial product transaction could be severely disadvantaged in the event of a legal dispute about the validity of the contract, as the counterparty would only need to show that the informed party failed to disclose some material price-sensitive information that was not generally available or known to the counterparty. Arguably, failure to disclose some price-sensitive information in a private

dealing should not be visited with such serious criminal, as well as civil, consequences as are applicable under the insider trading provisions.

Policy options

2.30 The Advisory Committee raises for consideration whether the current insider trading laws should:

- continue to apply in their current form, or
- not apply, or
- be limited to disclosable information, or
- be changed in some other manner

for these private transactions. The merits of the second and third policy options are discussed below.

Exclude the insider trading laws

2.31 An argument for exclusion is that it is for the parties to private bilaterally negotiated contractual arrangements to determine what matters they should disclose to each other. The insider trading laws should not seek to interfere with, or override, mutually agreed contractual terms.

2.32 A contrary consideration is that at least those private off-market transactions in marketable securities that must be reported either pursuant to the stock exchange requirement (ASX Business Rule 2.15) or under the substantial shareholding provisions may have a material impact on the market price of those securities. Insider trading in off-market reportable transactions can therefore materially affect the pricing mechanism on the Exchange market.

2.33 A total exclusion would also give the Australian legislation a much narrower application than those overseas jurisdictions that apply their laws to off-market transactions in market-tradeable securities.

Apply insider trading law with disclosable information element

2.34 Another policy option would be to apply the insider trading laws, with the disclosable information element, to all off-market transactions in quoted securities. This would cover any information that, of itself, the market would expect to be publicly disclosed, either now or in the future. In this context, the market would be any financial market in which that type of transaction could take place. For instance, a private transaction in ASX-tradeable securities would be assessed according to the disclosure expectations of the ASX market.

Advisory Committee position

2.35 The Advisory Committee is giving consideration to the various policy options. The Committee welcomes comments.

Transactions under non-discretionary trading plans

[Discussion Paper paras 2. 148–2.152 and Appendix 6]

Current Australian Law

2.36 Persons who lawfully enter into any trading plans are nevertheless precluded from further trading under those plans once they become aware of any relevant inside information, until such time as that information becomes generally available.

2.37 This lack of flexibility under the current Australian law may make it difficult or impossible for directors and other persons involved in management to sell their company's shares, even at pre-determined dates, under a trading plan lawfully entered into in good faith, notwithstanding the importance that some shareholders may place on directors taking shares in the company in lieu, in whole or part, of fees.

US exemption for non-discretionary plans

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

2.39 This Rule draws no distinction between on-market and off-market transactions. It can apply in both circumstances.

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

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

Possible adoption of US Rule in Australia

2.41 The US Rule could apply to trading plans involving either the purchase or sale of financial products. Theoretically, persons could have a number of trading plans on foot. However, their only permissible discretion while they are aware of inside information would be to terminate a trading plan (given that any decision not to trade is permissible under US law as well as Australian law). They could not activate a trading plan, nor change its terms, during that time.

2.42 Rule 10b5-1 provides a safe harbour from insider trading only where:

- the trading took place in accordance with an irrevocable plan entered into when the person was not aware of any inside information, and

- that plan was entered into in good faith and not as part of a plan or scheme to evade the insider trading prohibitions. It would overcome the possibility of a person entering into a number of concurrent plans that have an overall neutral effect and subsequently terminating those plans that would not be profitable given later obtained inside information.

2.43 Defendants could have a legal onus to prove both these elements, rather than merely an evidential onus to raise them.

Transactions in unlisted entities

[Discussion Paper paras 2.93–2.98]

Current law

2.44 The insider trading laws apply to transactions in unlisted as well as listed entities. In consequence, the prohibition, and its criminal and civil consequences, can apply to essentially private transactions in private businesses, including even family proprietary companies, notwithstanding that these transactions have no perceivable effect on Australian financial markets. By contrast, most overseas jurisdictions confine their insider trading provisions to transactions that have some direct or indirect link to a public market.

Policy options

2.45 The Advisory Committee raises for consideration whether the current insider trading laws should:

- continue to apply in their current form, or
- not apply, or
- apply where there is a link to listed entities, or
- be changed in some other manner

for transactions in unlisted entities. The merits of the second and third policy options are discussed below.

Exclude unlisted entities

2.46 One policy option is to exclude transactions in the securities or other financial products of some or all unlisted entities. For instance, the insider trading legislation could exempt financial products of proprietary companies (of whatever size) and those of any other unlisted entity with 50 or fewer members.

2.47 This policy option would overcome an apparent anomaly under the current insider trading law. For instance, an unlisted entity, such as a small business, can be sold by selling either the assets or the shares of the corporate entity. In the former instance, parties rely on contractual representations and warranties in the event of non-disclosure; in the latter, non-disclosure may result in criminal liability for insider trading.

Apply the insider trading laws where there is a link to listed entities

2.48 Another approach would be to apply the insider trading laws only to those transactions in unlisted entities that directly affect listed entities.

2.49 Assume, for instance, that a person has inside information that would materially affect the price or value of the securities of Listed Company A. The informed person is also aware that Pty Co B is the controlling shareholder of Co A and that Pty Co C holds some Co A shares. The informed person seeks to acquire Pty Co B or Pty Co C shares.

2.50 The legislation could provide that any exemption for trading in unlisted entities not apply to any informed person where:

- the otherwise exempt unlisted entity has a direct or indirect interest in the financial products of a listed entity and those financial products constitute at least a substantial part of the unlisted entity's assets, and
- the inside information about the listed entity would also materially affect the price or value of the transaction involving the unlisted entity's shares.

Advisory Committee position

2.51 The Advisory Committee is giving consideration to the various policy options. The Committee welcomes comments.

3 Matters that should be changed

Overview

3.1 In this chapter, the Advisory Committee outlines its current thinking on those matters raised in the Discussion Paper, and not dealt with in Chapter 1 or Chapter 2, that the Advisory Committee considers require legislative change. These changes are primarily designed to clarify or strengthen these laws and ensure that they are fully enforceable.

3.2 The Committee proposes legislative changes that would:

- strengthen the provisions requiring directors to notify trading in their own, or any related companies', securities
- amend the test of generally available information
- introduce rebuttable presumptions that senior corporate officers are aware of inside information originating within, or known to, the company
- repeal the on-selling exemption for underwriters
- repeal the statutory exemption for external administrators
- clarify that the relevant time for on-exchange transactions is when an offer is accepted by the counterparty broker
- permit the exercise of physical delivery option rights
- extend the Chinese Walls defence to procuring
- extend the 'own intentions' defence to anyone trading on behalf of a takeover bid consortium
- protect uninformed procured persons from civil liability where the procurer received no direct or indirect benefit
- extend the equal information defence to civil proceedings
- permit courts to extend the range of civil claimants beyond the insider's immediate counterparty.

Strengthen the reporting requirement for directors

[Discussion Paper paras 4.1–4.12]

The issue

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

Advisory Committee view in the Discussion Paper

3.4 The Advisory Committee considered that the requirement for directors of listed companies to disclose their trading in their company's securities reflects the market's legitimate interest in being aware of these transactions. Disclosure also reduces the opportunity for any particular director to engage in insider trading without detection. However, the current statutory disclosure obligations are seriously deficient and require significant strengthening. The Committee put forward a series of proposals in the Discussion Paper to strengthen them.

Submissions

3.5 The Submissions generally recognised that the current provision did not ensure that the market was sufficiently and promptly informed about directors' transactions in their own companies. The Submissions favoured strengthening the provision, though respondents differed on some of the details.

Current Advisory Committee view

3.6 The Advisory Committee supports the following amendments to s 205G.

- the provision should apply to all entities listed on the ASX, other than exempt foreign entities (the directors of entities incorporated overseas are subject to the disclosure requirements of their incorporating jurisdiction)
- the disclosure obligation should apply to directors, the chief executive officer and other senior executives, for instance, the five most highly paid executives or those executives who report directly to the chief executive officer. The disclosure obligation on these persons should cover any direct trading and any trading through related parties
- the disclosure obligation should extend to disclosure of trading in the shares of a listed entity by the directors of any other entity that manages the affairs of the listed entity pursuant to a management agreement
- where a director has resigned from that position, the disclosure obligation should cover any relevant transactions that occurred before that time
- with off-market transactions, a copy of the contract should also be disclosed
- the obligation should be to disclose the closest approximate number of securities whenever it is not possible, given the particular transaction, to know the exact number

- the disclosure period should be reduced from 14 days to 2 business days, except for changes arising under dividend (distribution) re-investment plans which should remain at 14 days. Compare the US Public Company Accounting Reform and Investor Protection Act 2002, which reduces the mandatory period for senior executives and principal shareholders of US public companies to disclose changes in ownership of their company's securities to 2 business days after the changes occurred

- the information to be disclosed under this provision should not include changes arising from *pari passu* changes equally applicable to all shareholders, such as capital reconstructions or bonus issues. These *pari passu* changes should only be subject to any applicable periodic or annual disclosure obligations.

3.7 The Committee does not support a materiality threshold that would permit directors to transact in small quantities without disclosure.

Amend the test of generally available information

[Discussion Paper paras 2.1–2.50]

The issue

3.8 One of the elements of insider trading is that the information not be generally available. Currently, information is generally available if it is either publishable information or a readily observable matter. Should these tests be reformulated?

Advisory Committee view in the Discussion Paper

3.9 The Advisory Committee discussed the merits of reformulating these twin tests by giving priority to the publishable information test and reviewing the meaning of readily observable matter.

Submissions

3.10 Most of the Submissions acknowledged that some clarification of these tests was necessary, particularly in light of a number of recent judicial decisions. However, views differed on the appropriate tests for determining readily observable matter.

Readily observable matter

3.11 There were essentially two approaches on how to apply the three elements of the readily observable matter test raised in the Discussion Paper, namely:

- observable to whom

- how observable, and

- where observable.

3.12 These two approaches also differed on whether there should be a dissemination period.

3.13 *Observable to whom.* On the first approach, the matter must be observable by a cross-section of investors (that is, persons who commonly invest in financial products of a kind whose price or value might be affected by the information).

3.14 On the second approach, a matter is readily observable either if it is disclosed in a public area or can be observed by the public without infringing rights of privacy, property or confidentiality. Only one of these alternatives has to be satisfied.

3.15 *How observable.* On the first approach, the matter must be readily observable without resort to technical assistance beyond that likely to be used by a cross-section of investors. For instance, information on the Internet would satisfy the test, but not information visible only through an electron microscope.

3.16 On the second approach, a matter is readily observable even if other users of the market cannot obtain it because of limitations on their resources, expertise or competence or it is only available on payment of a fee.

3.17 *Where observable.* On the first approach, the matter would have to be observable at least by investors in Australia.

3.18 On the second approach, a matter is readily observable even if it is only available overseas.

3.19 *Dissemination period.* On the first approach, a readily observable matter must have been readily observable for a reasonable period to allow dissemination.

3.20 On the second approach, there should be no change to the current law, which permits persons to trade immediately when they become aware of a readily observable matter.

Current Advisory Committee view

Publishable information

3.21 The Advisory Committee supports retaining the current test, which it interprets as being confined to information that will come into the public domain without the need for any further intermediate steps. The legislation could clarify this matter if necessary.

Readily observable matter

3.22 *If the disclosable information concept is adopted.* Chapter 1 of this Proposals Paper discussed the merits of introducing a disclosable information concept into the definition of inside information. This concept, if adopted, may eliminate the need for the readily observable matter (ROM) test of when information is generally available. The ROM test was introduced late in the legislative process that led to the 1991 insider trading amendments, apparently to meet concerns about the potential breadth and open-ended nature of those amendments. However, the disclosable information concept excludes information that, even though price-sensitive, is not the type of information that market users would expect to be publicly disclosed either now or in the future.

3.23 In consequence, the ‘excess stocks in the yard’ example used in the Explanatory Memorandum to justify the ROM test would not be disclosable information, as it would not be information that regular users of a market would expect

to be publicly disclosed. The test of when information is generally available could therefore be confined to the current publishable information test.

3.24 *If the disclosable information concept is not adopted.* The Advisory Committee seeks views on the merits of the two approaches raised by Submissions on the Discussion Paper.

Introduce rebuttable presumptions

[Discussion Paper paras 2.133–2.141]

The issue

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

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

Advisory Committee view in the Discussion Paper

3.26 The Advisory Committee raised these matters for consideration, noting that obtaining corroborative evidence that a person was subjectively aware of inside information can be one of the most difficult aspects of insider trading law enforcement.

Submissions

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

Current Advisory Committee view

3.28 To introduce rebuttable presumptions into legislation that carries criminal as well as civil penalties is a serious matter. Legitimate concerns may arise from any alteration to the principles requiring the prosecution to prove all the elements of the offence. However, rebuttable presumptions can be justified in limited circumstances for senior officers, given their likely access to inside information known to the company. Limited rebuttable presumptions could also overcome the considerable evidential difficulties of independently proving subjective knowledge in these circumstances.

3.29 The prosecution should have to prove that any information alleged to be inside information was not generally available. However, directors and other senior officers should then be subject to rebuttable presumptions that:

- they were aware of that information if it was generated within, or otherwise known to, the company, and
- they were aware that this information was not generally available.

3.30 The Advisory Committee does not support a rebuttable presumption that these persons were aware that the information is price-sensitive. This element requires an analytical assessment that differs from that required for the other two presumptions of knowledge.

3.31 The two rebuttable presumptions would apply to criminal, civil penalty and civil proceedings. They would reinforce the due diligence obligations of directors and other senior officers to fully inform themselves before transacting in their company's financial products.

3.32 A person could satisfy the presumptions by obtaining, for instance, prior confirmation from the chief executive officer that there was no price-sensitive information known to the company that had not been publicly disclosed.

3.33 The Advisory Committee has considered the merits of extending the rebuttable presumptions to any other person who the court believes should be subject to those presumptions, given the closeness of their association with the matters in question. The Advisory Committee does not support this extension. It would mean that some persons may be uncertain whether they are subject to the rebuttable presumptions (and therefore must provide evidence in rebuttal), until they go to court.

Repeal the on-selling exemption for underwriters

[Discussion Paper paras 2.159–2.166]

The issue

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

Advisory Committee view in the Discussion Paper

3.35 The Advisory Committee considered that there was no clear justification for permitting underwriters with inside information to on-sell their securities to uninformed counterparties.

Submissions

3.36 The Submissions were divided on whether to retain the on-selling exemption. Some Submissions supported repealing this exemption, while another respondent argued that removal of the on-selling exemption may increase underwriting risk and underwriting fees and reduce the availability of underwriters.

Current Advisory Committee view

3.37 The Advisory Committee does not support the on-selling exemption, except for sales to other underwriters/sub-underwriters. The Committee was not provided with any evidence that removal of the on-selling exemption would necessarily increase underwriting risk and fees or decrease underwriting availability.

Repeal the statutory exemption for external administrators

[Discussion Paper paras 2.167–2.171]

The issue

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

Advisory Committee view in the Discussion Paper

3.39 The Advisory Committee considered that the rationale for the current exemption for liquidators, personal representatives of deceased persons and trustees in bankruptcy was not readily apparent. The exemption could be seen as contrary to the principles of market fairness and market efficiency, even though these persons would not gain personally from securities trading while holding inside information. Given this, it was also questionable whether administrators, scheme managers, or receivers and managers should have any equivalent exemption.

Submissions

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

Current Advisory Committee view

3.41 A statutory exemption for any class of external administrators is unnecessary. An external administrator could in some instances disclose the inside information before selling or, alternatively, seek a court direction, for instance, under s 424 or s 447D, to sell affected financial products.

Clarify the relevant time for on-exchange transactions

[Discussion Paper paras 2.172–2.182]

The issue

3.42 Persons with inside information may attempt to trade through intermediaries. At what point have they breached the legislation?

Advisory Committee view in the Discussion Paper

3.43 The Advisory Committee identified three options for determining the relevant time for on-exchange transactions:

- *when the client gives instructions to a broker.* An informed client would be liable at this time. Conversely, a client who at that time was not aware of inside information would not breach the legislation, even where the client subsequently became aware of any inside information

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

- *when the offer is accepted by another exchange trader.* This would reflect the decision in the *Mt Kersey* case. A client who received inside information in the period between instructing the broker and the offer being *accepted* would be obliged to take all reasonable steps to withdraw the offer to avoid breaching the legislation.

3.44 The Committee noted that any of these policy options could have anomalous results. For instance, a person could be liable for insider trading under the first or second policy option, even where no trading took place. The third policy option would avoid this problem, but would require a person who became aware of inside information after instructing a broker to act diligently to withdraw any affected offer that had not been accepted.

Submissions

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

Current Advisory Committee view

3.46 The Advisory Committee agrees on the need for certainty. There are arguments for and against each of these options. However, on balance, the Advisory Committee supports the third option whereby the relevant time for a transaction occurs when the exchange trader on the opposite side of the contract accepts the offer. There is no counterparty (who may suffer detriment through the insider trading) until the offer has been accepted.

Permit exercise of physical delivery option rights

[Discussion Paper paras 2.117–2.132]

The issues

3.47 There are two related issues.

- *Informed party exercising option rights.* Persons may, when they are not aware of inside information, lawfully enter into option contracts under which they may buy (call options) or sell (put options) particular securities within, or at the end of, a specified period. Should they be permitted to exercise their physical delivery call or put rights (against the counterparty or the clearing house) if in the meantime they become aware of relevant inside information, thereby becoming informed persons?

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

Advisory Committee view in the Discussion Paper

Informed party exercising option rights

3.48 Persons who enter into fixed price physical delivery option contracts when they are not aware of inside information should be entitled to exercise their physical delivery rights, notwithstanding that they hold inside information at the time of exercise. For the reasons set out in para 2.126 of the Discussion Paper, the exemption should be limited to fixed price contracts to ensure against possible abuse.

Uninformed party requiring the exercise of option rights

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

Submissions

Informed party exercising option rights

3.50 The Submissions were divided.

3.51 One view was that the exercise of option rights in these circumstances could distort the market if they are only being exercised because the option holder has price-sensitive information that is not generally available. Also, it has been suggested that an exemption may increase the incentive for informed persons to conceal inside information about the real value of the underlying securities.

3.52 Some other respondents acknowledged that informed persons in these circumstances may be assisted in determining whether to exercise the option, and in that respect have an advantage over other option holders. However, the insider trading

provisions should not seek to deal with this advantage, given that the person only became an informed person after entry into the option contract. Also, in some instances, informed persons may have a fiduciary duty not to publicly release the inside information at the relevant time. Furthermore, there is no advantage to them in withholding the information from the market, given that the exercise price is already fixed.

Uninformed party requiring the exercise of option rights

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

Current Advisory Committee view

Informed party exercising option rights

3.54 The Advisory Committee supports the principle of informed persons being able to exercise fixed price physical delivery option rights. These persons should be entitled to the benefit of rights for which they contracted in good faith and before they became informed persons.

3.55 The Advisory Committee has considered whether limited classes of persons, such as directors and senior officers, should be required to notify the market before exercising their physical delivery option rights in relation to any of their company's securities. This information would benefit other market participants. However:

- the mandatory disclosure could be misleading, as the market may incorrectly guess the reasons for the foreshadowed exercise of the options
- it would need to be made clear how far down the corporate chain the test of senior officers would apply.

3.56 The Advisory Committee invites submissions on this advance disclosure proposal.

Uninformed party requiring the exercise of option rights

3.57 Uninformed persons should be entitled to require informed counterparties to honour their physical delivery obligations.

Extend the Chinese Walls defence to procuring

[Discussion Paper paras 2.190–2.195]

The issue

3.58 Should persons who satisfy the Chinese Walls defence be protected against the offence of procuring, as well as trading and disclosing?

Advisory Committee view in the Discussion Paper

3.59 The Advisory Committee noted that, as drafted, the Chinese Walls statutory defences may not apply to the prohibited conduct of procuring another person to

transact in a regulated financial product. This may result in the insider trading provisions being unduly wide.

Submissions

3.60 All the Submissions on this matter supported an amendment to remove the procuring anomaly.

Current Advisory Committee view

3.61 The Chinese Walls defence should cover the procuring offence.

3.62 The Advisory Committee also notes the ASX proposal to amend the statutory Chinese Walls defences to require that intermediaries 'establish, maintain and enforce policies and procedures' for effective Chinese Walls. This proposal could be further considered in the context of any future review of the Chinese Walls defence.

Permit bid consortium members to trade for the consortium

[Discussion Paper paras 2.209–2.111]

The issue

3.63 Should the 'own intentions' exemption cover a person in a takeover bid consortium who trades on behalf of that consortium, but not through the intended bid entity, in the period before the bid becomes generally known? Currently, this exemption only applies to the entity that conducts the takeover bid.

Submissions

3.64 Most Submissions that commented on this issue supported any insider trading exemption applying only to purchasers on behalf of the consortium collectively. Individual consortium members should not otherwise have an exemption.

Advisory Committee view

3.65 The 'own intentions' exemption should apply to a person who trades on behalf of a bid consortium.

Protect uninformed procured persons from civil liability

[Discussion Paper paras 3.13–3.17]

The issue

3.66 Under the current insider trading laws, persons procured by insiders may be required to disgorge any profit made or loss avoided in their transactions. Should those persons be exempt from civil liability where they are uninformed?

Advisory Committee view in the Discussion Paper

3.67 Any exemption from civil disgorgement liability for procured persons should only apply where the procured person was not aware of the inside information and the insider who procured that person did not receive any direct or indirect benefit from the transaction.

Submissions

3.68 Most Submissions supported this exemption, though they were divided on who should have the onus or proof.

Current Advisory Committee view

3.69 A procured person who is unaware of inside information should not be civilly liable for disgorgement where the procured person establishes that the procurer did not receive any direct or indirect benefit from the transaction.

Extend the equal information defence to civil proceedings

[Discussion Paper paras 3.18–3.23]

The issue

3.70 Should the equal information defence that currently applies in criminal proceedings be extended to civil proceedings?

Advisory Committee view in the Discussion Paper

3.71 The same defence should apply in criminal and civil proceedings, namely that the counterparty to the transaction 'knew or ought reasonably to have known' of the inside information.

Submissions

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

Current Advisory Committee view

3.73 The insider trading legislation should provide an equal information defence in civil proceedings similar to the defence that applies in criminal proceedings, given that no mischief occurs where the counterparty knows, or should know, of price-sensitive information that is not generally available.

Permit courts to extend the range of civil claimants

[Discussion Paper paras 3.24–3.43]

The issue

3.74 Who should be entitled to seek compensation for insider trading?

Advisory Committee view in the Discussion Paper

3.75 The Advisory Committee sought comments on the merits of extending the category of compensation claimants beyond the insider's counterparty. The Committee noted that some jurisdictions provide compensation for 'contemporaneous traders', being persons who traded on the opposite side of the market to the insider at or about the same time as the insider, whether or not their orders were matched with those of the insider.

Submissions

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

Current Advisory Committee view

3.77 The insider trading legislation should be cast widely enough to enable a court to extend the range of claimants beyond the insider's immediate counterparty. The level of compensation to each claimant would reduce as the number of claimants is increased. However, the amount of available funds could depend on whether the court is given power to impose penalties of a multiple of the profit gained or loss avoided.

4 Matters that should not change

Overview

4.1 In this chapter, the Advisory Committee outlines its current views on those matters raised in the Discussion Paper that the Advisory Committee considers may not require change.

4.2 In summary:

- entities as well as natural persons should continue to be subject to the insider trading prohibition
- whether a person is an insider should continue to depend on the information that the person holds (the 'information connection' approach), rather than the person's direct or indirect relationship with the company (the 'person connection' approach)
- the current requirement that the insider trading laws only apply where trading takes place should remain
- informed persons who lawfully disclose inside information should not be required to inform the recipient that the information is inside information
- there should be no requirement that inside information be specific or precise
- it should not be an element of the insider trading offence that an informed person has used the inside information in trading
- the prohibition on informed persons trading should continue to apply where they trade contrary to inside information
- the current communication and subscription exemptions for underwriters should remain
- intermediaries should remain liable for aiding and abetting when acting for clients whom they know (rather than merely suspect) to have inside information
- the current prohibition on informed intermediaries acting on behalf of uninformed clients, even only on an execution-only basis, should remain
- there should be no derivative civil liability for the controllers of persons who engage in insider trading
- there is no need to adjust the insider trading laws for directors of takeover target companies or their white knights
- there should be no requirement for Exchanges to publish any information about any referrals they make to ASIC on suspected insider trading

- there should be no move to confine criminal sanctions to fiduciaries and other connected persons, with anyone else in breach of the insider trading provisions being subject to only civil penalty liability
- any further review of ASIC's administrative powers, or whether penalties of a multiple of the profit gained or loss avoided should be introduced, should await the forthcoming Report of the Australian Law Reform Commission (ALRC) on *Civil and Administrative Penalties in Australian Federal Regulation*. The ALRC issued a Discussion Paper in April 2002
- the current rules for assessing compensation in civil proceedings should remain
- companies whose securities are traded should continue to have civil remedies
- there is no need for specific legislation to prohibit speculative trading by corporate decision makers in the securities of their companies
- there is no need for specific legislation to introduce a 'short swing profit' prohibition.

Regulate entities as well as natural persons

[Discussion Paper paras 1.48–1.56]

The issue

4.3 The insider trading provisions apply to all 'persons', whether natural persons or any other entity (including corporations and partnerships). Should those provisions be confined to natural persons?

Submissions

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

Advisory Committee view

4.5 The Advisory Committee favours the definition of insider continuing to include entities as well as natural persons. Limiting the legislation to natural persons could undermine any incentive for entities to control the flow of information within their organisations.

Maintain only 'information connection' approach

[Discussion Paper paras 1.57–1.74]

The issue

4.6 Should insiders continue to be defined under an 'information connection' test only (that is, according to their possession of relevant inside information) or should there be an additional 'person connection' test (which, for the most part, would require

some direct or indirect connection or relationship to the source or owner of the information, such as the company whose securities are traded)?

Submissions

4.7 Most Submissions favoured the 'information connection' test, without any alternative or additional 'person connection' test, arguing that:

- the 'person connection' concept is a remnant of the misappropriation or fiduciary rationales for the prohibition of insider trading. The relevant factor under the (more appropriate) market fairness and efficiency rationales is equal level of access to information, not one's relationship to the source of that information
- the requirement to establish a connection between the insider and the entity whose financial products are traded makes enforcement unduly complicated, especially where there are separate tiers of insiders, for instance, if the prosecution must establish that a secondary insider knew that the source of the information was a primary insider
- a 'person connection' test may increase the difficulty of proving knowledge of each of the elements of an accessorial liability offence
- the person connection test may create greater opportunities to avoid the prohibition by disguising any connection between the secondary insider and the source.

4.8 Some respondents who supported the 'person connection' test argued that confining the definition in this manner would permit persons who are not connected with a company to obtain and trade on the basis of information derived from their own discovery without the restrictions imposed by the insider trading laws.

Advisory Committee view

4.9 The broader 'information connection' approach, rather than the more limited 'person connection' approach, better reflects the market fairness and market efficiency rationales. It is also more conceptually straightforward than the 'person connection' approach. It therefore assists market participants to understand the insider trading laws, while avoiding many of the complexities, uncertainties and gaps in coverage that can arise under the 'person connection' approach.

Continue to exclude non-trading

[Discussion Paper paras 1.75–1.107]

The issue

4.10 An insider may lawfully use inside information for the purpose of refraining from trading, disclose this information to any other persons for that purpose or procure another person not to trade. Should the legislation extend to non-trading?

Submissions

4.11 The Submissions were divided.

4.12 Some Submissions favoured a blanket prohibition on disclosing inside information, or procuring, without a lawful excuse, whether the result was trading or failure to trade. A recipient may receive a benefit by deciding not to trade or cancelling a trading order.

4.13 Other Submissions favoured a continuation of the current law, which, in effect, permits communication of information, or procuring, to discourage trading. They argued that in these circumstances no party in the market would have gained an advantage or suffered any disadvantage.

Advisory Committee view

4.14 The Advisory Committee does not support imposing liability for non-trading, as there is no adversely affected counterparty. However, the Committee notes that in some circumstances selective release of inside information or advice to discourage trading could breach the continuous disclosure or other disclosure obligations or the fiduciary duties of confidentiality.

No requirement to inform recipients that they are receiving inside information

[Discussion Paper paras 1.75–1.107]

The issue

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

Submissions

4.16 The Submissions were divided.

4.17 Those supporting a requirement to inform argued that it would better ensure that recipients cannot exploit this information for their own benefit.

4.18 Other Submissions opposed any such requirement as being unworkable.

Advisory Committee view

4.19 The Advisory Committee does not support imposing any obligation to inform the recipient that the information is inside information, as this could create considerable difficulties in commercial communications.

Inside information need not be specific or precise

[Discussion Paper paras 2.51–2.61]

The issue

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

Submissions

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

- the additional requirement would make the proof of a contravention to a criminal standard more difficult. In some instances, it is not possible to precisely identify what information was possessed, as the prosecution may need to rely on evidence of the defendant's access to information and inferences from that person's conduct
- the need to show that information is material or that a reasonable person would expect that, if generally available, the relevant information would be price-sensitive avoids the need to consider whether the requisite degree of specificity or precision has been achieved.

Advisory Committee view

4.22 The Advisory Committee does not support any requirement that inside information be specific or precise. To introduce this requirement could unduly narrow the application of the legislation and create artificial distinctions between what does and what does not constitute information.

No use requirement

[Discussion Paper paras 2.142–2.147, 2.150–2.151]

The issue

4.23 Should criminal liability for insider trading require that a person holding inside information has used (relied on) that information in trading? Alternatively, should a person have a defence that he or she did not use the information?

Submissions

4.24 Most Submissions opposed any use requirement, as it would create a significant additional hurdle to effective enforcement of the insider trading laws.

4.25 Some Submissions favoured a defence of non-use. However, other Submissions opposed this defence, arguing that:

- it may enable defendants to disguise their real motivation for trading

- a requirement to prove whether the non-public information or another reason was the predominant motivation for a trade would be unproductive, and probably contrary to at least the appearance of fairness in the capital markets.

Advisory Committee view

4.26 The insider trading legislation should not have a use requirement or a defence of non-use.

4.27 Experience from US case law points to the great difficulties that any prosecutor may face in proving that a defendant actually used inside information in consummating particular transactions.

4.28 A defence of non-use may enable individuals to erect plausible screens to disguise their real motivation for trading. It may be a simple matter for a trader, with the benefit of hindsight, to suggest numerous reasons for trading other than the possession of inside information.

No exemption for trading contrary to inside information

[Discussion Paper paras 2.153–2.158]

The issue

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

Submissions

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

- it would simply complicate an already complicated offence
- the courts or the regulator can best decide how to deal with a person who trades contrary to inside information
- insiders could use a right to trade contrary to inside information as a smoke screen while concealing other trades
- examining a trade in isolation may provide little information, given that trades can be engineered to form an exotic risk allocation (for instance, a straddle, a butterfly)
- an insider should not be permitted to derive windfall gains, even when contrary to expectations
- in some situations it is difficult to determine how the inside information will affect the price of securities.

Advisory Committee view

4.31 The Advisory Committee does not support any defence that an informed person traded contrary to inside information.

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

Retain the communication and subscription exemptions for underwriters

[Discussion Paper paras 2.159, 2.161– 2.164]

The issues

4.33 Should an underwriter continue to be permitted to:

- communicate inside information solely for the purpose of procuring a person to enter into an underwriting or sub-underwriting agreement
- subscribe for securities pursuant to an underwriting agreement before inside information given to the underwriter becomes generally available?

Submissions

4.34 All Submissions that commented on this Issue supported the exemption permitting underwriters to communicate inside information solely for the purpose of procuring a person to enter into an underwriting or sub-underwriting agreement. This right of communication was essential to enable underwriters to properly perform their functions.

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

Advisory Committee view

4.36 The Advisory Committee supports retaining the communication and subscription exemptions as being necessary for the effective functioning of the underwriting industry.

Intermediaries to remain liable for aiding and abetting

[Discussion Paper paras 2.183–2.188]

The issue

4.37 Should an intermediary be permitted to carry out a client's instructions to trade for the client in particular financial products if that client has revealed to the intermediary inside information concerning those products or the fact that the client holds inside information? Currently, an intermediary who transacts for the client in these circumstances may be liable for aiding and abetting the insider trading breach by the client.

Submissions

4.38 The Submissions generally supported prohibiting a broker who is aware that a client has inside information from trading in affected financial products on behalf of that client. This approach reinforces the market fairness and market efficiency rationales of insider trading laws.

Advisory Committee view

4.39 The Advisory Committee supports the current law under which an intermediary who has knowingly received inside information from a client, or has been informed by the client that the client holds inside information, could be liable for aiding and abetting by trading in affected financial products for that client.

No exemption for informed intermediaries acting for uninformed clients

[Discussion Paper para 2.189]

The issue

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

Submissions

4.41 Submissions generally favoured permitting an informed intermediary to act for any uninformed clients on an execution-only basis.

Advisory Committee view

4.42 The Advisory Committee notes that, under existing law and practice, an intermediary with inside information cannot trade in affected financial products, even on an execution-only basis on behalf of uninformed clients.

4.43 The Committee does not favour an exemption unless there is clear evidence that major problems have arisen in practice under the current law.

No derivative civil liability for controllers

[Discussion Paper paras 2.196–2.208]

The issue

4.44 In what circumstances, if any, should anyone 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?

Submissions

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

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

Advisory Committee view

4.47 In some instances, firms could be liable for aiding and abetting insider trading breaches, depending upon their level of knowledge of the unlawful behaviour. Beyond that, they should not be subject to derivative civil liability. Instead, firms could risk considerable reputational damage if their employees engage in insider trading on their own behalf.

No exemption for directors of takeover targets or their white knights

[Discussion Paper paras 2.212–2.225]

The issues

Target company directors

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

White knights

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

Submissions

Target company directors

4.50 Some Submissions supported the legislation permitting target company directors to communicate inside information to another party solely for the purpose of encouraging that person to act as a white knight and where the target company directors took all reasonable steps to ensure that the white knight did not purchase target company shares from uninformed counterparties before the information became generally available.

4.51 Another view was that there should be no allowance for target company directors to selectively disclose inside information to white knights, or for white knights to subscribe for new shares on this basis. Any information given to a white knight should be concurrently released to the market.

White knights

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

Advisory Committee view

Target company directors

4.53 There should be no statutory safe harbour for target company directors, as it could be open to abuse, given the uncertainty of its ambit. Rather this matter should be left to industry best practice.

White knights

4.54 There should be no statutory exemption for white knights.

No obligation on Exchanges to publish their insider trading referrals

The issue

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

Submissions

4.56 One respondent suggested that there may be a public interest in an Exchange disclosing that it has made a referral to ASIC on a possible breach of the insider trading laws. The information published could be limited to the stock, the period of trading, the pattern of trading and the size of the potential profits involved. Suspect individuals would not be named.

Advisory Committee view

4.57 The Advisory Committee does not support this proposal. It has concerns regarding procedural fairness and privacy, and that the market may draw inappropriate and unjustified conclusions about the identity of particular traders. Also, publication could prematurely alert possible suspects, who could then destroy evidence or otherwise impede the investigative process.

No differing criminal and civil insider trading regimes

The issue

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

Submissions

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

Advisory Committee view

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

No recommended reform of ASIC's enforcement powers

[Discussion Paper paras 3.1–3.12]

The issue

4.61 Are the remedies given to ASIC in relation to insider trading appropriate and sufficient?

Submissions

4.62 Some Submissions supported the regulator having the power to impose administrative penalties for insider trading, arguing that these non-judicial proceedings are more effective and timely than resort to litigation. Some other Submissions argued that administrative penalties should not be considered until there has been sufficient

time to assess the extension of the civil penalty regime to insider trading in March 2002.

4.63 The Submissions were divided on whether ASIC should have the power to recover a multiple of the profit gained or loss avoided.

Advisory Committee view

4.64 Any further review of ASIC's administrative powers, or whether penalties of a multiple of the profit gained or loss avoided should be introduced, should await the forthcoming Report of the Australian Law Reform Commission on *Civil and Administrative Penalties in Australian Federal Regulation*.

No change to compensation assessment rules

[Discussion Paper paras 3.24–3.43]

The issue

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

Submissions

4.66 Most Submissions supported the current method of assessing compensation, rather than that used under Canadian legislation, which requires the court to use an 'average market price' formula to assess compensation to each eligible claimant, being:

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

Advisory Committee view

4.67 The existing rules for assessing what constitutes profit made or loss avoided should remain. The alternative Canadian average price formula test would run the risk of the price being influenced by external factors occurring within the 20 trading day period.

Retain civil remedies for companies whose securities are traded

[Discussion Paper paras 3.44–3.52]

The issue

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

Submissions

4.69 Some Submissions favoured the current law permitting companies to recover compensation. One of those respondents argued that a company has an interest in maintaining an orderly market in its own securities.

4.70 Other Submissions opposed this right for companies, in the absence of their suffering actual loss.

Advisory Committee view

4.71 The existing law, under which companies whose financial products are traded can recover, should remain, even where those companies have suffered no loss or damage. This provides an incentive for companies to monitor trading in their own securities.

No speculative trading provision

[Discussion Paper paras 4.13–4.19]

The issue

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

Submissions

4.73 Some Submissions favoured controls over speculative trading, arguing that:

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

4.74 However, other Submissions opposed these controls, noting that directors were already subject to fiduciary duties. They argued that a better approach would be to

encourage listed entities to adopt policies on trading by executives and officers, for instance, by requiring listed entities to disclose their policies on this subject.

Advisory Committee view

4.75 There should be no new statutory prohibition on speculative trading, given that the law on the fiduciary duties of directors already regulates this matter.

No short swing profit provision

[Discussion Paper paras 4.20–4.30]

The issue

4.76 Should there be a 'short swing profit' prohibition, similar to that found in US corporate law? Currently, there is no specific provision dealing with short swing profits.

Submissions

4.77 Most Submissions opposed this prohibition, arguing that it assumes that directors and executive officers are always and inevitably in possession of unpublished price-sensitive information. 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.

Advisory Committee view

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