

Companies and Securities Advisory Committee

Insider Trading
Discussion Paper

June 2001

Functions of the Advisory Committee

The Companies and Securities Advisory Committee (the Advisory Committee) was established under Part 9 of the Australian Securities and Investments Commission Act 1989 (the ASIC Act). Subsection 148(1) of the ASIC Act sets out its functions:

The Advisory Committee'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 a national scheme law, or to make amendments of a national scheme law;*
- (b) the operation or administration of a national scheme law;*
- (c) law reform in relation to a national scheme law;*
- (d) companies, securities or the futures industry; or*
- (e) a proposal for improving the efficiency of the securities markets or futures markets.*

Membership 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, the financial markets, law, economics or accounting.

The members during preparation of this Discussion Paper were:

Richard St John (Convenor) – formerly Corporate General Counsel & Company Secretary, The Broken Hill Proprietary Company Ltd, Melbourne

Reg Barrett – formerly Partner, Mallesons Stephen Jaques, Sydney

Philip Brown – Professor of Accounting, University of Western Australia, Perth

Alan Cameron AM – Chairman, Australian Securities and Investments Commission (to November 2000)

Patricia Cross – Company Director, Melbourne

Peter Griffin – Director, NM Rothschild Australia Holdings Pty Ltd, Melbourne

Leigh Hall AM

Greg Hancock – Director, Hancock Corporate and Investment Services, Perth

David Knott – Chairman, Australian Securities and Investments Commission (from November 2000)

Merran Kelsall – Company Director, Melbourne

John Maslen – Company Secretary & Chief Executive Administration, GH Michell & Sons (Australia) Pty Ltd, Adelaide

Marian Micalizzi – Chartered Accountant, FCA, Brisbane.

Secretariat

The members of the Secretariat involved in preparing this Discussion Paper were:

John Kluver – Executive Director

Vincent Jewell – Deputy Director

Thaumani Parrino – Executive Assistant.

Request for submissions

The Discussion Paper sets out 40 issues, covering all the subject areas discussed. The Advisory Committee has indicated its provisional views on each of these issues. However, these views are not settled. The Advisory Committee invites submissions on all of the matters raised in this Paper. Likewise, respondents are invited to raise any further issues, or reform options, affecting insider trading that are not canvassed in this Paper. The Advisory Committee will closely consider all submissions on this Paper before settling its Final Report.

Please send submissions either by Email to casac@casac.gov.au or by hard copy to:

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

If sending a hard copy, please also include, if possible, a computer disk using Microsoft Word 2000 or a lower version of Microsoft Word.

Advisory Committee Phone: (02) 9911 2950

Advisory Committee Fax: (02) 9911 2955

Closing date for submissions

Please forward submissions by **Friday 12 October 2001**.

Further copies

Further copies of this Discussion Paper are available on the ASIC Website (<http://www.asic.gov.au>) by going first to **Publications** and then clicking on **CASAC Papers** or by phoning the ASIC Infoline on 1 300 300 630.

Table of Contents

	Paras
Introduction	
Purpose of the Discussion Paper	0.1-0.5
Scope of the Discussion Paper	0.6-0.9
Acknowledgment	0.10
Interaction with the Financial Services Reform Bill	0.11-0.12
International comparison	0.13-0.14
Use of the term “securities”	0.15-0.16
Summary of issues	0.17-0.56
Chapter 1. Rationale and overview of insider trading regulation	
Incidence of insider trading	1.1-1.4
Outline of the Australian law	1.5-1.10
Rationales for prohibiting insider trading	1.11-1.35
What is inside information	1.36-1.47
Who are insiders	
Entities other than natural persons	1.48-1.56
Information connection or person connection	1.57-1.74
Liabilities of insiders	1.75-1.107
Chapter 2. Details of regulation	
Information covered	
Generally available information	2.1-2.50
Level of precision of the inside information	2.51-2.61
Insider trading and continuous disclosure	2.62-2.67
Research and analysis: mixing research and inside information	2.68-2.75
Research and analysis: trading before publishing one’s own research	2.76-2.84
Transactions covered	
Financial products covered by the prohibition	2.85-2.92
On-market and off-market application of insider trading prohibition	2.93-2.98
An entity issuing new securities	2.99-2.106
An entity buying back its issued securities	2.107-2.116
Exercise of physical delivery option rights by informed persons	2.117-2.126
Exercise of physical delivery option rights by uninformed counterparties	2.127-2.132
Subjective elements	
Awareness and knowledge of inside information	2.133-2.141
Use of inside information	2.142-2.152
Trading contrary to inside information	2.153-2.158

Exemptions	
Underwriting	2.159-2.166
Transactions by external administrators	2.167-2.171
Intermediaries	
Liability of an insider when trading through an intermediary	2.172-2.182
Intermediary acting on clients' instructions	2.183-2.189
Internal controls over insiders	
Persons trading on behalf of an entity: the Chinese Walls defence	2.190-2.195
Persons trading on their own behalf: derivative civil liability	2.196-2.208
Takeovers	
Bidders	2.209-2.211
Target company directors	2.212-2.219
White knights	2.220-2.225
Chapter 3. Remedies	
Regulator's remedies	3.1-3.12
Persons civilly liable	
Uninformed procured persons	3.13-3.17
Equal information defence	3.18-3.23
Persons entitled to compensation	
Market participants	3.24-3.43
Companies whose securities are traded	3.44-3.52
Chapter 4. Other provisions	
Director notification of securities holdings	4.1-4.12
Speculative trading by corporate decision makers	4.13-4.19
Prohibition on short swing profits	4.20-4.30

Appendix 1. Financial Services Reform Bill Comparison

Appendices 2-11. International comparisons

Introduction

Purpose of the Discussion Paper

0.1 The Australian insider trading laws generally prohibit any person who is aware of confidential price-sensitive information affecting the price or value of particular securities from trading in those securities, disclosing that information to any persons likely to trade or procuring another person to trade in those securities. Similar prohibitions apply to futures contracts and will apply to other financial products on enactment of the Financial Services Reform Bill.

0.2 The current Australian laws, introduced in 1991, replaced earlier legislation. The Advisory Committee is reviewing these laws in light of experience since that date and concerns about their effectiveness in some respects and possible undue constraints in other respects.

0.3 Effective and enforceable law to combat insider trading is necessary to ensure healthy financial markets in which investors can have confidence. There is a strong community view that insider trading is reprehensible and should be prosecuted. Increasing levels of share ownership and market participation in Australia have heightened this general community expectation. In some areas, the insider trading provisions may need to be strengthened.

0.4 Insider trading laws should not, however, unduly impede the legitimate operation of financial markets. Market participants should not be discouraged from conducting research and analysis, which promote the efficiency of these markets. Legitimate property rights in research should be protected. In some areas, the insider trading provisions may need to be clarified or modified to avoid undue constraints.

0.5 Insider trading laws also need to be clear and workable, so that all parties know where they stand. For instance, corporate managers, financial services providers and legal advisers should not be subject to undue uncertainty in their ability to deal in securities in conformity with the law, or advise on that law. Lack of clarity may result in reduced compliance as well as unproductive uncertainty for the market.

Scope of the Discussion Paper

0.6 This Discussion Paper reviews the insider trading laws under Chapter 7 of the Corporations Law (Securities), which were substantially amended in 1991. It does not discuss the insider trading provisions in Chapter 8 of the Corporations Law (Futures Markets), which are still based on the insider trading principles prior to the 1991 amendments. Futures contracts will be regulated in the same manner as securities after enactment of the Financial Services Reform Bill. All references in this Paper are to the Corporations Law, unless otherwise indicated.

0.7 Other Corporations Law provisions complement the insider trading rules. The continuous disclosure regime helps ensure that all market participants have an opportunity to be promptly and accurately informed about price-sensitive developments affecting the securities of listed entities. The requirement for prompt

disclosure also reduces the opportunities for insider trading. Likewise, the requirement for directors of listed companies to notify their securities holdings in their companies also seeks to reduce the likelihood of insider trading without detection. However, this requirement may need to be strengthened considerably to make it more effective.

0.8 This Paper does not discuss some other corporate law principles that may apply to particular instances of insider trading, such as the obligation of company directors not to breach their fiduciary duties of loyalty by making improper use of corporate information.

0.9 The Paper does not discuss selective disclosures to outsiders, such as private briefings to corporate analysts, which, while they may not involve disclosure of inside information, still raise questions of fairness and equal access to corporate information. Selective disclosure is the subject of ongoing initiatives by the Australian Securities and Investments Commission (ASIC), including guidance given in the ASIC Papers *Heard it on the Grapevine* (1999) and *Better Disclosure for Investors* (2000). Key elements of ASIC's disclosure principles are that listed companies should:

- have written policies and procedures on information disclosure that focus on continuous disclosure compliance and improving access to corporate information for all investors
- have a website on which information is posted as soon as it is disclosed to the market, and
- nominate a senior officer with responsibility for ensuring compliance with continuous disclosure and overseeing and co-ordinating information disclosure to the Stock Exchange, analysts, brokers, shareholders, the media and the public.

Acknowledgment

0.10 The Advisory Committee acknowledges the assistance it derived in developing this Paper from presentations made by Michael Hoyle (Director, Macquarie Corporate Finance), Stephen Kerr (Partner, Freehill Hollingdale & Page), Joseph Longo (then National Director, Enforcement, Australian Securities and Investments Commission) and Alan Shaw (then National Manager, Supervision, Australian Stock Exchange Limited) at an Insider Trading Seminar conducted by the Centre for Corporate Law and Securities Regulation of the University of Melbourne in July 2000.

Interaction with the Financial Services Reform Bill

0.11 The Financial Services Reform Bill was released in April 2001. This Bill applies the current Chapter 7 insider trading provisions, with only limited amendments, to a broader range of financial products. The relationship between the Bill's provisions and the current Chapter 7 provisions is summarised in Appendix 1.

0.12 The changes to the insider trading provisions under the Bill were intended to be minimal only and to leave open the possibility of further legislative amendments that might arise in consequence of this Advisory Committee review.

International comparison

0.13 This Paper reviews the Australian law in the context of comparable provisions and recent initiatives in the United Kingdom, Germany, South Africa, the United States, Canada, New Zealand, Singapore and Malaysia. A detailed outline of the law in each of these jurisdictions, as well as the European Union Insider Trading Directive, and a draft new EU Directive, is set out in Appendices 2-11.

0.14 This international comparison indicates that there is no single agreed model for regulating insider trading. Instead, it highlights the range of possible legislative responses to market issues and may suggest useful approaches in some areas to achieve the best insider trading laws for Australia. Harmonisation of insider trading laws, where appropriate, also has important practical implications for cross-border trading.

Use of the term “securities”

0.15 The insider trading provisions in all overseas jurisdictions apply to securities, with some jurisdictions extending their provisions to other financial products. Likewise, in Australia, the existing insider trading legislation covers securities and futures contracts (though by different provisions). The Financial Services Reform Bill proposes to apply the insider trading provisions to securities, futures contracts and various other financial products.

0.16 For the sake of convenience, this Paper refers throughout only to insider trading in securities. This avoids the complexities of having to differentiate between the financial products covered in each jurisdiction.

Summary of issues

0.17 The Advisory Committee supports the principles underlying the Australian insider trading legislation and most of its existing provisions. It should be noted that, in almost every respect, the Australian insider trading laws are stronger in their terms than comparable overseas laws. This does not mean, however, that adjustments may not be called for or that, in practice, the law is necessarily fully effective.

0.18 In this Paper, the Advisory Committee has raised 40 Issues for further consideration. The Committee has indicated its provisional views on each of these Issues, though the Committee will further consider these matters in light of submissions on this Paper. Respondents are also invited to raise any other issues they consider relevant to insider trading.

0.19 The Committee’s views on the Issues in this Paper may be grouped into:

- matters that should not be changed
- matters that may require legislative change

- other possible changes for consideration.

Matters that should not be changed

Rationale underlying the legislation

0.20 The Advisory Committee supports the market fairness and market efficiency principles that underlie the existing Australian insider trading laws. The fiduciary duty and misappropriation rationales that underlie insider trading laws in some other jurisdictions are too narrow.¹

Who are insiders

0.21 Insiders should continue to include all persons, not just natural persons.² In consequence, the Chinese Walls defence should remain.³

0.22 The Australian “information connection” only approach, which defines insiders as anyone who has confidential price-sensitive information, should be retained, without any additional “person connection” element (as in overseas jurisdictions), which, for the most part, would require some direct or indirect connection between informed persons and the owner or source of the information, such as the entity whose securities are traded.⁴

Information covered

0.23 There should be no requirement that inside information be specific or precise.⁵

0.24 The insider trading and continuous disclosure laws complement each other. The insider trading provisions should continue to cover matters that are exempt under the continuous disclosure requirements.⁶

0.25 There should be no statutory exemption to permit persons to trade before publishing their own price-sensitive reports or recommendations.⁷

Transactions covered

0.26 Options and warrants over equity indices should continue to be covered by the insider trading prohibition.⁸

Subjective elements

0.27 The legislation should not be amended to require the prosecution to show that a person holding inside information used that information when trading, or to provide a defence that the defendant did not use that information when trading.⁹

¹ paras 1.34-1.35.

² paras 1.54-1.56.

³ paras 2.193-2.194.

⁴ paras 1.73-1.74.

⁵ paras 2.60-2.61.

⁶ paras 2.66-2.67.

⁷ paras 2.81-2.84.

⁸ para 2.87.

0.28 The legislation should not be amended to introduce a defence that an insider traded contrary to inside information.¹⁰

Exemptions

0.29 The current exemption that permits companies to communicate inside information solely for the purpose of procuring a person to enter into an underwriting or sub-underwriting agreement should remain.¹¹

Takeovers

0.30 There should be no change to the existing prohibition on a “white knight” purchasing shares from existing shareholders either when aware of a confidential impending price-sensitive hostile bid or when in possession of any other inside information.¹²

Matters that may require legislative change

Information covered

0.31 The definition of inside information should continue to apply to information regardless of its source, but should be amended to exclude information that relates only to securities generally or to issuers of securities generally.¹³

0.32 The test of generally available information should give priority to the publishable information limb of that test over the readily observable matter limb. The circumstances where a reasonable dissemination period is required under the publishable information limb should be extended.¹⁴

Transactions covered

0.33 The legislation should introduce a rule similar to SEC Rule 10b5-1, which permits persons to structure securities trading plans, to be implemented in the future, provided that those persons are not aware of inside information at the time of settling these plans and have no discretion over those plans if they later become aware of inside information. This Rule would be relevant to:

- companies issuing or purchasing their own securities¹⁵
- employee share plans or dividend re-investment plans¹⁶
- persons who conduct research and analysis.¹⁷

⁹ paras 2.150-2.151.

¹⁰ paras 2.157-2.158.

¹¹ para 2.163.

¹² paras 2.223, 2.225.

¹³ paras 1.46-1.47.

¹⁴ paras 2.25-2.40.

¹⁵ paras 2.104-2.106 (new share issues), 2.114-2.116 (buy-backs).

¹⁶ para 2.152.

¹⁷ paras 2.74-2.75.

0.34 The legislation should permit option holders who only become aware of relevant inside information after they have lawfully entered into an option contract (informed persons) to exercise their option rights to purchase or sell securities, provided that the contract stipulates a fixed exercise price.¹⁸

0.35 Uninformed counterparties to informed persons under option contracts should be entitled to require those persons to honour their contractual obligations to purchase or sell securities.¹⁹

Intermediaries

0.36 The legislation should make clear that, where a person trades through an intermediary, the relevant transaction for the purpose of the insider trading provisions occurs when the exchange trader on the opposite side of the contract accepts the offer.²⁰

0.37 The legislation should prohibit a broker to whom a client has given inside information from transacting in affected securities on behalf of that client.²¹

Internal controls over insiders

0.38 The current legislative Chinese Walls defence to trading should also apply to procuring.²²

Equal information defence

0.39 The legislation should provide an equal information defence in civil proceedings similar to the defence that applies in criminal proceedings.²³

Director notification of securities holdings

0.40 The current provision requiring directors of listed companies to notify the exchange of any changes to their holdings of securities in the company or any related company should be amplified to overcome its limitations. There should be no minimum material change threshold for notification.²⁴

Other possible changes for consideration

Liabilities of insiders

0.41 The legislation could:

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

¹⁸ paras 2.123-2.126.

¹⁹ paras 2.131-2.132.

²⁰ paras 2.180-2.182.

²¹ paras 2.188-2.189.

²² para 2.195.

²³ para 3.23.

²⁴ paras 4.6-4.12.

- require a person lawfully disclosing inside information to inform the recipient that the information is inside information
- impose liability on insiders for procuring if, on the basis of inside information, they “discourage or stop” another person from dealing in affected securities.²⁵

Information covered

0.42 The readily observable matter limb of the generally available information test could be clarified, though this may not be essential, given the proposal to give priority to the publishable information limb of that test.²⁶

Transactions covered

0.43 The category of financial products subject to the insider trading provisions could exclude derivatives over commodities.²⁷

0.44 The insider trading legislation could be confined to securities and other financial products that satisfy any of the following tests, namely they are traded or capable of being traded on a financial market, they give an indirect interest in a tradeable financial product or they involve a financial services provider.²⁸

Subjective elements

0.45 The legislation could introduce a rebuttable presumption that directors and other managers are aware of any confidential price-sensitive information derived from within their companies and/or a rebuttable presumption that they are aware that this information is inside information.²⁹

Exemptions

0.46 Underwriters may be adequately protected without the current subscription exemption, which could therefore be repealed. The on-selling exemption for underwriters may not be justifiable and, if so, could be repealed.³⁰

0.47 The current exemption for liquidators, personal representatives of deceased persons and trustees in bankruptcy may not be justifiable and, if so, could be repealed. Alternatively, if the exemption is justifiable, it could be extended to other external administrators.³¹

Internal controls over insiders

²⁵ paras 1.106-1.107.

²⁶ paras 2.41-2.50.

²⁷ paras 2.88-2.92.

²⁸ paras 2.96-2.98.

²⁹ paras 2.139-2.141.

³⁰ paras 2.164-2.166.

³¹ paras 2.170-2.171.

0.48 Persons who are in a position to control or supervise the activities of other persons could be made civilly liable for insider trading by those other persons if the controlling or supervising persons knew or recklessly disregarded the likelihood of insider trading and failed to take appropriate preventative steps.³²

Takeovers

0.49 Any exemption for pre-bid buying by a consortium contemplating a takeover bid might only apply to any purchases made on behalf of that consortium. Individual consortium members should not otherwise have an exemption.³³

0.50 Target company directors could have a defence to the disclosing and procuring offences if they show that they communicated any inside information merely for the purpose of encouraging a person to be a white knight and took all reasonable steps to ensure that the white knight did not transact in issued target company shares before that information became generally available.³⁴

Regulator's remedies

0.51 The civil penalty provisions could provide for recovery of a multiple of the profit gained or loss avoided in insider trading. ASIC could be given the power to disburse money received under the civil penalty regime to eligible claimants, using a contemporaneous trading test. ASIC could also be given the power to impose administrative penalties.³⁵

Liability of procured persons

0.52 The legislation could exempt from civil liability for the profit made or loss avoided any uninformed persons who were procured by an insider to trade, provided that the insider did not receive any direct or indirect benefit from the transaction.³⁶

Compensation rights

0.53 The legislation could define eligible claimants as all “contemporaneous” traders, not just counterparties to insiders. Alternatively, these compensation rights could be repealed.³⁷

0.54 The legislation could limit the compensation rights for companies whose securities are traded to any actual losses suffered. Alternatively, the existing compensation rights for these companies could remain, but with the court having a discretion over the distribution of funds recovered for these companies.³⁸

Speculative trading by insiders

³² paras 2.206-2.208.

³³ para 2.211.

³⁴ para 2.219.

³⁵ paras 3.11-3.12.

³⁶ paras 3.15-3.17.

³⁷ paras 3.36-3.43.

³⁸ paras 3.50-3.52.

0.55 Directors and other corporate decision makers could be prohibited from short selling their company's securities or transacting in various options over those securities.³⁹

Prohibition on short swing profits

0.56 Directors and executive officers could be required to disgorge any profits received from buying and subsequently selling their company's securities within a six month period.⁴⁰

³⁹ para 4.19.

⁴⁰ paras 4.27-4.30.

Chapter 1

Rationale and overview of insider trading regulation

This Chapter examines fundamental concepts underlying the prohibition on insider trading, including the purpose of insider trading laws, what constitutes inside information, who should be subject to regulation and for what behaviour. The Advisory Committee considers that insider trading laws are essential to promote market fairness and market efficiency and that the fundamental principles of the Australian legislation are sound and should be retained.

Incidence of insider trading

1.1 There is an inherent risk of some level of insider trading in any financial market. Various overseas studies have confirmed likely insider trading on securities markets. They indicate that directors, senior officers and other persons connected with a cross-sample of listed companies tended to trade in an advantageous manner in their company's securities (that is, they purchased shares or options before an abnormal market price rise, or sold these securities before an abnormal market price fall) more frequently than can reasonably be explained by chance.⁴¹ Takeovers appear to provide a particular opportunity for advantageous pre-bid trading.⁴²

1.2 Australian research gives some support to these findings, including in the context of takeovers,⁴³ and also indicates that some persons would be willing to engage in insider trading if given the opportunity.⁴⁴

⁴¹ Lakonishok and Lee, "Are Insiders' Trades Informative?", *Review of Financial Studies*, 2001, Jeng, Metrick and Zeckhauser, "The Profits to Insider Trading: A Performance-Evaluation Perspective", *Harvard University Working Paper*, 1999.

⁴² Arnold, Erwin, Nail and Bos, "Speculation or insider trading: Informed trading in options markets preceding tender offers", *University of Alabama at Birmingham Working Paper* (2000) state that corporate insiders (that is, directors and senior officers) trade prior to takeover announcements in the USA and use the options market (where it is available), as well as the equity (underlying) market. They hide their activities among those of other informed traders to avoid attracting the attention of market participants and observers. Likewise, Jabbour, Jalilvand and Switzer, "Pre-bid price run-ups and insider trading activity: Evidence from Canadian acquisitions", *International Review of Financial Analysis* (2000) argue that abnormal stock price rises at an early stage before a takeover bid's announcement are due to trading by corporate insiders in Canada.

⁴³ P Brown and M Foo in "Insider Trading in Australia: Evidence from Directors' Trades", *University of Western Australia Working Paper 1998-93* report that information collated from directors' disclosures of changes in their interests in their own companies (under s205G) suggests a tendency for Australian directors' sales (but not purchases) to be profitable. In particular, directors' sales tend to occur after abnormal price rises and are followed by abnormal price declines.

ID Watson and A Young in "A Preliminary Examination of Insider Trading around Takeover Announcements in Australia", *University of Western Australia Working Paper 1999-113* report that, relative to other times, directors of ASX-listed target companies buy more often and in larger parcels before the announcement of a takeover bid and are sellers after the announcement.

1.3 The likely existence of some insider trading emphasises the importance of strong and clear insider trading laws. Treating insider trading as a criminal offence, with the possibility of suspected persons being subject to investigation and criminal proceedings, may act as a strong deterrent to some persons, although it is unrealistic to expect full compliance with any law.

1.4 The clear trend is towards a more comprehensive ban on insider trading on financial markets worldwide. Over 80% of countries with stock markets, including all OECD countries, have insider trading laws. All countries reviewed in this Paper, other than New Zealand, treat insider trading as a criminal offence. Also, many jurisdictions have moved within the last decade to introduce, or significantly strengthen, their insider trading laws.

Outline of the Australian law

1.5 The current insider trading provisions for securities form an element of Part 7.11 of the Corporations Law, which regulates conduct in relation to securities. This Part distinguishes between general prohibited conduct (Part 7.11 Div 2) and insider trading (Part 7.11 Div 2A). In essence, general prohibited conduct deals with any false, fictitious, misleading, deceptive or fraudulent conduct, including market manipulation, market rigging or dissemination of false or misleading statements in relation to securities. By contrast, insider trading deals with a person trading on the basis of undisclosed price-sensitive information regarding a company's securities.

1.6 For insider trading to occur:

- a person must be aware of information
- that information must not be generally available
- a reasonable person would expect that information, if it had been generally available, to materially affect the price or value of securities of a particular entity, and
- the person must know, or ought reasonably to know, that the information was not generally available and was material.

1.7 Where these elements apply, the person in possession of the information (the insider) must not trade in these securities, procure any other person to trade in the

Increased buying activity occurs several weeks before the announcement and then again in the last week prior to the announcement.

⁴⁴ Just over half the respondents to a 1995 survey of senior corporate officers conducted by M Freeman and M Adams expressed a willingness to buy before a company's favourable announcement. Also, some 44% were more likely to buy a target company's shares before a takeover announcement. Just under half of those respondents said that they would trade to be rewarded for entrepreneurial skill and two thirds of that group said that they may do so even if it meant trading on inside information: M Freeman and M Adams, "Australian Insiders: Views on Insider Trading" (1999) 10 *Australian Journal of Corporate Law* 148.

The authors concluded that either the majority of senior insiders surveyed would commit insider trading if given the opportunity (given their belief that the prohibition was inadequate) or the respondents did not regard what they were doing as insider trading.

securities or communicate the information to anyone else who the insider knows, or ought reasonably to know, may so trade (or procure some other person to trade), unless there is an applicable exemption. However, there is no prohibition on an insider using inside information to decide not to trade,⁴⁵ or passing on the information to third parties to discourage them from trading.⁴⁶

1.8 Without some statutory qualifications, many legitimate commercial activities would be affected. The legislation therefore contains exemptions for persons who, pursuant to a legal requirement, communicate inside information or trade while in possession of inside information.⁴⁷ Likewise, directors may obtain share qualifications, trustees of employee pension or superannuation funds may acquire shares, personal representatives of deceased persons, liquidators and trustees in bankruptcy may enter into securities transactions, and securities may be sold under a mortgage or charge, without these transactions breaching the insider trading provisions.⁴⁸ There are other statutory exceptions, including for withdrawals from registered managed investment schemes.⁴⁹ Some of these statutory exceptions, and the various statutory defences to insider trading, are further discussed in this Paper.

1.9 The insider trading provisions only apply where one party has confidential price-sensitive information not available to the counterparty. There is no insider trading where both parties are equally informed, although in some instances there may be other unlawful conduct. For instance, there is overseas evidence that some senior executives, before the date at which the exercise price of executive options is to be fixed, manipulate the release of price-sensitive information before that date to obtain an abnormally low exercise price.⁵⁰ This is not insider trading, as both parties to the option contract (the executive and the company) would be aware of any confidential price-sensitive information that was withheld to affect the exercise price. This common knowledge would attract the equal information defence. However, the executive may be liable for breach of fiduciary duty to the company and, possibly, if this occurred in Australia, also for breach of the continuous disclosure requirements.

1.10 The insider trading laws do not cover every instance of unequal information between contracting parties. Insider trading only applies to transactions in securities (or other financial products). Persons are not prohibited from using confidential price-sensitive information for other purposes. For instance, a person can lawfully acquire or sell real property, even where that person, but not the counterparty, has confidential price-sensitive information affecting the value of that property. Private contract law regulates these arrangements.

⁴⁵ An example would be a person cancelling a previously given order to sell certain securities once aware of subsequently learned positive inside information.

⁴⁶ An example would be a person disclosing positive [negative] inside information to a recipient to discourage the recipient from selling [buying] particular securities.

⁴⁷ ss 1002K, 1002L.

⁴⁸ Corporations Regulations reg 7.11.01.

⁴⁹ s 1002H. Securities, for the purpose of the insider trading provisions, include interests in managed investment schemes: s 1002A(1) definition of “securities”.

⁵⁰ Chauvin and Shenoy, “Stock price decreases prior to executive stock option grants”, *Journal of Corporate Finance*, 2001. Using data on 783 stock-option grants to chief executive officers in the USA, the authors found a statistically significant abnormal decline in stock prices during the 10 day period immediately preceding the grant date.

Rationales for prohibiting insider trading

The issue

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

Current rationales

1.12 Various rationales for these laws have been put forward from time to time, including:

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

1.13 The *fiduciary duty* and *misappropriation* rationales, developed primarily in US corporate law, focus on misuse of information by persons having some fiduciary or similar relationship with a company whose securities are traded or the owner of the inside information (if the company is not the owner). By contrast, the *market fairness* and *market efficiency* rationales focus on the market impact of using inside information.

Fiduciary duty

1.14 A person who owes fiduciary duties to a company should not make a personal profit or avoid a loss by using the company's confidential price-sensitive information to trade in its securities. This trading may breach various fiduciary duties, including the duty of confidentiality, the duty not to use corporate information for personal gain and the duty to avoid conflicts of interest. This trading may also adversely affect the commercial standing or reputation of the company, including the value of its securities.

1.15 The scope of this fiduciary duty rationale is limited. For instance, corporate directors, officers and employees owe duties to their company, but not usually to counterparties in a public market.⁵¹ In consequence, the fiduciary duty concept would not prohibit an officer of a prospective bidder company, or an employee of a third party connected with the bidder company, from trading on-market in the shares of a target company prior to disclosure of the takeover bid.⁵² Also, any company whose

⁵¹ Under US corporate law, directors etc owe fiduciary duties to counterparties who are already shareholders of the company. In Australia, directors do not normally owe fiduciary duties to individual shareholders. However, a fiduciary duty may arise in some face-to-face transactions between a director and a shareholder: *Brunninghausen v Glavanics* (1999) 32 ACSR 294.

⁵² In *Chiarella v United States* 445 US 222 (1980), an employee of a printer gained access to confidential information that indicated the identity of various target companies for which the printer was printing takeover documents. The employee then traded in the target companies'

securities are traded by an insider could waive the fiduciary duty, thereby permitting the insider to trade with an uninformed counterparty free of any fiduciary duty constraints.

Misappropriation

1.16 Misappropriation of information involves a person (the user) trading while in possession of confidential price-sensitive information that belongs to some other entity to which the user owes a fiduciary duty (the owner). This misuse of proprietary rights over information may also detrimentally affect the commercial reputation of the owner of the information and the value of its securities.

1.17 The misappropriation rationale, as developed by US courts, encompasses and extends the earlier fiduciary duty rationale, as the owner of the information may not necessarily be the entity whose securities are traded. Indeed, in some instances, the inside information may be deliberately withheld from that entity. For instance, a prospective bidder company would be the owner of any confidential information that it intends to conduct a takeover bid for a target company. The misappropriation rationale would therefore extend to an officer of a prospective bidder company who traded in target company shares.⁵³

1.18 The misappropriation rationale has several limitations. For instance, it will be violated only if the user breaches a fiduciary duty to the owner of the information (or possibly has stolen the information from the owner). The courts may resort to artificial reasoning in some circumstances to establish this fiduciary relationship between the user and the owner of the information. For instance, in one US case, a psychiatrist traded on the basis of information learned from a patient. In applying the misappropriation rationale, the Court relied in large measure on the Hippocratic Oath to establish a duty by the psychiatrist not to use inside information obtained from the patient. The reasoning in this case seems strained.⁵⁴

shares before the takeover bids were announced. The Supreme Court held that the employee only owed fiduciary duties to his employer (the printing company). Accordingly, the employee escaped insider trading liability under the fiduciary duty rationale when trading in the target company shares.

⁵³ In *United States v O'Hagan* 117 S Ct 2199, 521 US 642 (1997), a partner in a law firm that was advising a prospective bidder purchased options over shares in the intended target company. The Court ruled that the partner, through his firm, had a duty not to misappropriate confidential price-sensitive information that belonged to the bidder. Under this theory, "a fiduciary's undisclosed, self-serving use of the principal's information to purchase or sell securities in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information" (2199 at 2207).

⁵⁴ *United States v Willis* 737 F.Supp. 269 (S.D.N.Y., 1990).

W Wang in "Stock Market Insider Trading: Victims, Violators and Remedies" 45 *Villanova Law Review* (2000) 27 at 52 gives the example of a bartender (Mr Server) who, while serving behind the counter, overhears confidential price-sensitive information in a conversation between customers. Mr Server trades in reliance on that information:

"Has Mr Server breached a duty to the customers? A lawyer owes a duty to a client not to trade on confidential information from the client. What about a bartender and a customer? Probably, the bartender has no duty to a customer, but this is not certain.

Has Mr Server breached a duty to his employer? That depends on the policy of the bar. If the bar prohibits insider trading by its employees based on information obtained during

1.19 Also, there will be no breach if the user discloses his or her trading intentions to the owner prior to trading (under the US provision)⁵⁵ or if the owner approves that use. In any of these instances, the user could trade with an uninformed counterparty free of any constraints. The misappropriation rationale focuses on protecting the rights of owners of confidential information, not participants in the market.

Market fairness

1.20 All market participants bear trading and other risks in their market dealings. These risks include that other participants have better skills to analyse the market, have access to better market research or respond more quickly to information as it comes into the public domain. Market participants with superior skill, time or commitment will therefore inevitably have a trading advantage.

1.21 Market fairness does not require the elimination of these risks or advantages. Likewise, market participants should not be discouraged from conducting research and analysis, which promote the efficiency of these markets. Indeed, skill, acumen and diligence should be encouraged. However, insider trading deals with situations where market participants who hold confidential price-sensitive information can take the premium from trading without the same risks that are run by other market participants, who cannot gain access to that information by ordinary research, skill or analysis.

Market efficiency

1.22 Insider trading may damage financial markets in various ways. Insiders may delay disclosure of price-sensitive information to give themselves time to trade. Insider trading may also reduce the incentive for local and foreign investors to participate in any market that gives a special trading advantage to holders of confidential price-sensitive information. Reduced market participation may have adverse effects on the overall liquidity of financial markets and the fundraising functions of those markets. Also, any move towards permitting insider trading may encourage persons to trade on false assumptions that key market participants have inside information, rather than relying on proper financial fundamentals. This could create opportunities for exploitation.⁵⁶

1.23 The proposition that insider trading may undermine investor confidence and therefore market efficiency has been subject to some empirical research. An international study has found that the cost of equity in a country is reduced by about

employment, then Mr Server's trade violates [the US insider trading prohibition] under the misappropriation doctrine."

⁵⁵ In *United States v O'Hagan*, supra, the Court stated: "The deception essential to the misappropriation theory involves feigning fidelity to the source of the information. If the fiduciary discloses to the source that he plans to trade on the non-public information, there is no deceptive device and thus no s 10(b) violation" (at 2209).

⁵⁶ For instance, a corporate insider could buy company shares, while aware that this could send false signals to the market that there is as yet unreleased positive price-sensitive information. That insider could subsequently sell the shares at a profit following a market reaction to that signal.

5% if insider trading laws are enforced. These results also suggest that countries that enforce insider trading laws have more liquidity in their stock markets.⁵⁷

Australian law

1.24 The 1989 Parliamentary Committee Report on insider trading (the Griffiths Report)⁵⁸ referred to the importance of having a clear policy basis for the regulation of insider trading. The Report rejected the notion that the scope of the insider trading laws should be limited to some concept of fiduciary duty or a theory of misappropriation. Instead, the Report stated that the basis of the Australian prohibition on insider trading is investor confidence in the operation of the market, that is, a combination of *market fairness* and *market efficiency*.⁵⁹ This was summarised in the Explanatory Memorandum to the 1991 amendments.

“Some commentators have suggested that regulation of insider trading is not necessary, as insider trading enhances the efficiency of the securities market through the faster dissemination of information. The Government’s policy view is, however, that it is necessary to control insider trading to protect investors and make it attractive for them to provide funds to the issuers of securities, for the greater and more efficient development of Australia’s resources. The effects of insider trading on investor confidence are regarded as outweighing any efficiencies arising from the faster dissemination of information which some commentators allege would accrue if insider trading were decriminalised.”⁶⁰

Overseas law

1.25 All four rationales for regulating insider trading have been put forward in overseas jurisdictions.

United States

1.26 US courts and commentators have not reached a consensus on the rationale for prohibiting insider trading. Originally, the *fiduciary duty* rationale was predominant. The courts, and the Securities and Exchange Commission (SEC), have also developed the *misappropriation* rationale, based on the improper acquisition and use of inside information by persons in breach of their duty not to use that information contrary to another person’s proprietary rights in that information.⁶¹

⁵⁷ U Bhattacharya and H Daouk, “The World Price of Insider Trading”, Working Paper, Indiana University (2000).

⁵⁸ Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Fair Shares for All: Insider Trading in Australia* (11 October 1990) (*Fair Shares for All*).

⁵⁹ *id.*, paras 3.3.4-3.3.6. See also *Fair Shares for All: Government Response*, para 29, which endorsed those views.

⁶⁰ Explanatory Memorandum para 307.

⁶¹ A detailed conceptual analysis of the fiduciary duty and misappropriation rationales is given in A Strudler & E Orts, “Moral Principle in the Law of Insider Trading” (1999) 78 *Texas Law Review* 375. A useful critique of these theories is also given by J Mannolini, “Insider Trading - The Need for Conceptual Clarity” (1996) 14 *Company and Securities Law Journal* 151. See also A Duggan, “The Insider Trading Laws - An Unsprung Trap” *Commercial Law Quarterly* vol 11, No 2, June 1997 at 7.

1.27 Some US courts have recognised a *market fairness* or *market efficiency* approach (albeit in the context of misappropriation), arguing that:

“ ... although informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated non-public information is unchecked by law. An investor’s informational disadvantage vis-à-vis a misappropriator with material, non-public information stems from contrivance, not luck; it is a disadvantage that cannot be overcome with research or skill”.⁶²

1.28 The US Securities and Exchange Commission has pointed to the adverse effect on *market fairness* and *market efficiency* if disclosures of confidential price-sensitive information to a limited number of persons (selective disclosure) and insider trading were permitted:

“In both cases, a privileged few gain an informational edge - and the ability to use that edge to profit - from their superior access to corporate insiders, rather than from their skill, acumen, or diligence. Selective disclosure has an adverse impact on market integrity that is similar to the adverse impact from illegal insider trading: investors lose confidence in the fairness of the markets when they know that other participants may exploit ‘unerodable informational advantages’ derived not from hard work or insights, but from their access to corporate insiders. The economic effects of the two practices are essentially the same.”⁶³

Europe

1.29 The *market fairness* and *market efficiency* rationales are reflected in the Preamble to the European Union 1989 Council Directive on Insider Trading, which notes that:

“... the smooth operation of [the securities market] depends to a large extent on the confidence it inspires in investors;

... the factors on which such confidence depends include the assurance afforded to investors that they are placed on an equal footing and that they will be protected against the improper use of inside information;

... by benefiting certain investors as compared with others, insider dealing is likely to undermine that confidence and may therefore prejudice the smooth operation of the market”.

1.30 Likewise, the UK Financial Services Authority argues that, if certain market participants have access to confidential price-sensitive information before it becomes generally available and they can trade on it to their own advantage, confidence in the

⁶² *United States v O’Hagan* 117 S Ct 2199 at 2210 (1997).

⁶³ SEC Release No 33-7881 (October 2000).

integrity of the market will diminish. On the other hand, confidence in the fairness of the market enhances its liquidity and efficiency.⁶⁴

1.31 The German Federal Ministry of Finance argues that:

“the exploitation of insider information means that trading is no longer even-handed, so that market participants may lose faith in the fairness of the market. There may be a risk of the trading volume declining, liquidity falling and the market losing its most important function, which is to balance supply and demand”.⁶⁵

South-East Asia

1.32 The Monetary Authority of Singapore considers that insider trading erodes the confidence of investors and is antithetical to *market fairness* and *market efficiency*.⁶⁶ Likewise, the promotion of an honest securities market and investor confidence in that market is the objective of the Malaysian legislation.⁶⁷

New Zealand

1.33 The New Zealand legislation is based on a modified version of the *fiduciary duty* rationale, namely breach of confidence:

“Statutory causes of action should be established to enable companies and persons who deal with insiders to obtain, by means of civil proceedings, redress for the mis-use of information that is held in confidence”.⁶⁸

Advisory Committee view

1.34 The *market fairness* and *market efficiency* rationales for prohibiting insider trading focus on the broader market implications of insider trading and its potential economic repercussions. Australian commerce, and the community generally, benefit from deep and liquid financial markets. The existence or perception of insider trading could discourage some domestic or foreign investors from participating in these markets.

⁶⁴ UK Financial Services Authority Consultation Paper 59, *Market Abuse: A Draft Code of Market Conduct* (July 2000) para 1.6. The Paper elsewhere points out that: “confidence in markets will be undermined if users believe that they have been unreasonably disadvantaged (whether directly or indirectly) by others in the market having improperly used relevant information which is not generally available ... That reduction in confidence will impair market efficiency, and market participants will in general be disadvantaged” (para 2.8).

⁶⁵ Federal Ministry of Finance (Bundesministerium der Finanzen), *Our Stock Exchange and Securities System* (2000) at 39.

⁶⁶ Monetary Authority of Singapore, *Insider Trading: Consultation Document* (January 2001).

⁶⁷ *Public Prosecutor v Chua Seng Huat* [1999] 3 MLJ 305.

⁶⁸ *Insider Trading - Report to the Minister of Justice by the Securities Commission* (New Zealand Securities Commission 1987, volume 1 p 49). The New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (November 2000) paras 183 ff recommends amendments to introduce a broader concept of “obligation of confidence”.

1.35 By contrast, the *fiduciary duty* and *misappropriation* rationales for regulating insider trading are too limited. They require that the insider owe some fiduciary or similar duty either to the company whose securities are traded or to the owner of the inside information. This provides opportunities for avoidance through private permissive agreements between insiders and these companies or owners. These rationales also generally ignore the impact of insider trading on financial markets and their participants. Also, there is a strong view that insider trading should remain a criminal offence. It should not be decriminalised or be left to the discretion of particular companies to control (as would be possible under the fiduciary duty or misappropriation rationales).⁶⁹

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

What is inside information

The issue

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

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

Australian law

1.38 The Griffiths Report made only one reference to the issue of whether the definition should adopt the narrow or broad approach, which could be taken as some support for adopting the narrow approach. It said:

“The offence of insider trading must have its genesis in the use of information derived from within a company.”⁷⁰

However, the relevant recommendation in the Griffiths Report made no mention of this matter.

1.39 The Corporations Law adopts the broad approach. Inside information is defined 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 securities of a body corporate”.⁷¹

⁶⁹ M Freeman and M Adams, “Australian Insiders: Views on Insider Trading” (1999) 10 *Australian Journal of Corporate Law* 148 at 156. According to the authors, over 80% of the respondents to their survey disagreed with the proposition that insider trading should be decriminalised or left to the discretion of individual firms to control.

⁷⁰ *Fair Shares for All*, para 4.3.5.

All information coming within this definition is covered, whether generated within the entity whose securities are traded (internally generated) or by some external source (externally generated).⁷²

1.40 Examples of externally generated price-sensitive information would be advisers trading in advance of conveying their trading recommendations to clients (scalping),⁷³ transacting on their own behalf before implementing their clients' instructions (frontrunning)⁷⁴ or transacting with knowledge of a client's trading strategy and in advance of receiving specific instructions based on that strategy (piggy backing).⁷⁵ All these situations would be caught.⁷⁶

1.41 The broad approach may also cover confidential price-sensitive information generated by one entity that also affects the price or value of securities of another entity. This issue arose (but was not decided) in *R v Evans and Doyle* (1999).⁷⁷ In this case, company A held confidential price-sensitive information about a mineral find on its tenement. That information indicated that the mineral find also extended into the adjoining tenement held by company B, and was therefore also material to the price of the securities of company B. Company B was not aware of that information. The directors of company A sought to acquire shares in company B. The Court did not rule on whether the directors of company A held inside information that prohibited them from trading in company B's shares (given that the case was decided on other grounds).

Overseas law

1.42 All overseas jurisdictions examined in this Paper adopt the broad approach to defining what is inside information, with no requirement for the company whose securities are traded to have generated the information.

1.43 Under the UK legislation, for instance, inside information means:

⁷¹ s 1002G(1)(a).

⁷² This follows from the broad concept of inside information in s 1002G(1), supported by the equally broad definition of "information" in s 1002A(1), the test of material effect on price or value of securities in s 1002C and the lack of any requirement in the Australian provisions that the insider be directly or indirectly connected with the company whose securities are traded (see para 1.62).

⁷³ The price-sensitive information would be the recommendation to the client, provided it satisfied the terms of s 1002G(1)(a), namely that it "is not generally available" but if it were generally available "a reasonable person would expect it to have a material effect on the price or value of securities" of the relevant company.

⁷⁴ The price-sensitive information would be the client's instructions, provided those instructions satisfied the terms of s 1002G(1)(a).

⁷⁵ The price-sensitive information would be the client's trading strategy, provided it satisfied the terms of s 1002G(1)(a).

⁷⁶ "Information" is defined to include matters relating to the intentions or likely intentions of a person: s 1002A. Section 1002P provides that a natural person does not contravene the insider trading provisions "merely because the person is aware that he or she proposes to enter into, or has previously entered into, one or more transactions or agreements in relation to securities" of a body corporate. This exception would not apply to scalping, frontrunning or piggy backing, given that the price-sensitive information is not the adviser's own intentions or activities, but the recommendation itself (scalping), the client's instructions (frontrunning) and the client's trading strategy (piggy backing).

⁷⁷ Supreme Court of Victoria, 15 November 1999.

“information which relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally”.⁷⁸

1.44 The German legislation has been applied to frontrunning and scalping.

1.45 The ambit of the insider trading laws in each jurisdiction is limited in that they only apply to those persons holding inside information who are also primary or secondary insiders (see paras 1.64-1.72) and accordingly, by definition, are for the most part in a position to receive information sourced from within a company.

Advisory Committee view

1.46 The Advisory Committee supports the broad approach. To adopt the narrow approach could unduly restrict the ambit of the insider trading provisions by, for instance, excluding information about a raider’s intentions to bid for the securities of a target company. Market participants are entitled to expect that any person with whom they transact does not have an unerodable advantage through access to price-sensitive information, from whatever source generated, that is not available to the market generally or to market participants who research generally available information.

1.47 The broad definition could nevertheless be amended to make it clear that it covers only non-public information that relates to a company or its securities, rather than information that has only a general market application. Information about general economic or other developments may have an impact on the price of a particular company’s securities as well as on the market more generally. There is a question whether insider trading legislation should cover such information. The UK legislation clarifies this issue by excluding from the definition of inside information any information that relates “to securities generally or to issuers of securities generally”. This qualification could be added to the Australian legislation.

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

Who are insiders

Entities other than natural persons

The issue

1.48 Should the insider trading provisions apply only to natural persons?

⁷⁸ UK Criminal Justice Act 1993 s 56(1)(a).

Australian law

1.49 The insider trading legislation applies to all “persons”, whether natural persons or any other entity (including corporations and partnerships).⁷⁹ There are Chinese Walls provisions to permit entities to trade, even where some persons in the organization have confidential price-sensitive information.

Overseas law

1.50 The UK and South African laws only apply to natural persons (“individuals”). However, these persons are liable whether they act on their own behalf or on behalf of some other natural person or entity. Thus, insiders cannot avoid the prohibition merely by using a corporate or other entity to trade.

1.51 Other jurisdictions do not restrict the insider trading laws to natural persons.

1.52 Various reasons have been put forward for confining the insider trading law to natural persons. One UK commentator observed that:

“Corporate bodies were excluded [under the UK legislation] not because it was thought undesirable to make them criminally liable but because of the difficulties it was thought would be faced by merchant banks when one department of the bank had unpublished price-sensitive information about the securities of a client company and other departments had successfully been kept in ignorance of that information by a ‘Chinese Wall’ or otherwise. One of those other departments might deal in the shares, in which event the bank as a single corporate body would arguably have committed an offence had the act applied to corporate bodies.”⁸⁰

1.53 A South African insider trading law reform report stated that:

“In view of the lack of development in our law of the jurisprudence concerning the efficacy of the Chinese Wall, the Task Group decided that both the criminal offence of insider trading and the civil remedy set out in the proposed legislation should be limited to conduct by an individual.”⁸¹

Advisory Committee view

1.54 An argument for confining the legislation to natural persons is that it could simplify the legislation by removing the need for any Chinese Walls defence, without permitting individuals to avoid the prohibition by using a corporate or other entity to trade. This would also avoid the debate on whether a Chinese Walls defence is workable and effective in financial organizations (see paras 2.190 ff).

1.55 An argument against confining the legislation to natural persons is that the current prohibition obliges entities to create communication barriers between their

⁷⁹ Subsection 1002G(1) applies to any “person”, which in turn is defined in s 85A to include a body politic or corporate as well as an individual.

⁸⁰ *Gower's Principles of Modern Company Law* (6th Edition, Sweet & Maxwell, 1997) at 458.

⁸¹ *Final Report by the King Task Group into Insider Trading Legislation* (October 1997) at para 3.1.2.

research and trading sections in order to attract the Chinese Walls defence. Limiting the legislation to natural persons could undermine any incentive for entities to control the flow of information within their organizations.

1.56 Also, confining the legislation to natural persons would permit companies to issue their own securities without being subject to the insider trading provisions. The Advisory Committee elsewhere proposes that this corporate activity should not be exempt from the insider trading provisions (see paras 2.104-2.106).

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

Information connection or person connection

The issue

1.57 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)?

Australian law

1.58 *Person connection.* The Australian law prior to the 1991 amendments adopted a “person connection” test, which distinguished between primary and secondary insiders. A primary insider was any person holding confidential price-sensitive information who also was (or had recently been) “connected” with the corporation whose securities were traded. Connected persons included any director, officer or substantial shareholder of the company or a person having a business relationship with the company.

1.59 A secondary insider (or “tippee”) was any person who had knowingly received inside information from a primary insider in circumstances where the primary insider and the secondary insider were either associated or had an arrangement for the communication of such information.

1.60 *Information connection.* The 1991 amendments to the Corporations Law abolished this “person connection” approach. The Griffiths Report was very critical of the technicalities involved in the definitions of primary and secondary insiders under the pre-1991 legislation and the possible ways to avoid them.⁸²

1.61 The Griffiths Report noted that it is the use of inside information, not a person’s connection with the company whose securities are traded or some other entity, which can detrimentally affect the market:

“The [pre-1991 amendment] prohibition requiring the person to be connected to the corporation which is the subject of the information unnecessarily complicates the issue. It is the use of information, rather than the connection

⁸² *Fair Shares for All* paras 4.7.1 - 4.7.9.

between a person and the corporation, which should be the basis for determining whether insider trading has occurred.”⁸³

1.62 The Australian prohibition now adopts an “information connection” approach only, without the additional “person connection” concepts of primary and secondary insiders. An insider is any person who possesses information and who “knows or ought reasonably to know” that the information “is not generally available” and “might have a material effect on the price or value” of securities.⁸⁴ If these tests are satisfied, it makes no difference how, or from whom, that person has obtained the information. For instance, an informed person need not, in addition, have any direct or indirect connection with the owner or source of the information, such as the company whose securities are traded. Instead, the definition of insider covers all persons who knowingly obtain inside information, even by chance.⁸⁵

1.63 An overseas commentary supports the Australian approach:

“Nothing more needs to be said other than that an insider is a person in possession of inside information. In other words, the definitional burden in the legislation should fall on deciding what is inside information and the definition of insider should follow as a secondary consequence of this primary definition The proposal that insiders should be defined as those in possession of inside information would to some extent reduce uncertainty, because the only question that would have to be asked is whether the individual was in possession of inside information and the additional question of whether the individual met the separate criteria for being classed as an insider would be irrelevant.”⁸⁶

Overseas law

1.64 Unlike Australia, most overseas jurisdictions do not define insiders merely by reference to their possession of inside information. They narrow the category of insiders to those informed persons who also have some direct or indirect connection with the source of the information or satisfy some other employment or fiduciary duty criteria (“person connection” approach). This “person connection” approach also distinguishes between primary and secondary insiders, though the tests employed vary

⁸³ *Fair Shares for All*, para 4.3.5.

⁸⁴ s 1002G(1).

⁸⁵ The Explanatory Memorandum to the 1991 amendments discussed the position of a person who overhears confidential price-sensitive information. It pointed out that, given the terms of s 1002G(1)(b), “a person who, for example, overhears information in a lift or on the street and trades on the basis of that information would only be in breach of the provisions if he/she was aware [or ought reasonably to have known] that the information was inside information” (para 342).

⁸⁶ *Gower's Principles of Modern Company Law* (Sweet & Maxwell, 6th Edition, 1997) at 464-465.

between jurisdictions.⁸⁷ However, a few jurisdictions have followed the Australian model by adopting the “information connection” only approach to who are insiders.⁸⁸

1.65 *Primary insiders.* These are defined somewhat differently in each jurisdiction, but largely fall within the following categories:

- *direct connection:* persons having a direct connection with the company whose securities are affected by the inside information, for instance the company itself,⁸⁹ a director of the company⁹⁰ or a related company,⁹¹ other company officers,⁹² an employee of the company,⁹³ a shareholder of the company⁹⁴ or a related company,⁹⁵ affiliates or associates of the company⁹⁶ and other persons in a special relationship with the company.⁹⁷ However, in some instances, the person must come into possession of inside information “by virtue of” that person’s connection with the company
- *employment:* persons who have access to inside information by virtue of their employment, office or profession⁹⁸
- *fiduciary duty:* persons having a fiduciary or similar duty to the company whose securities are traded, to the counterparty or to the source of the inside information.⁹⁹

1.66 It is arguable that, under the employment category, there must be a causal link between the employment, office or profession and the acquisition of the information.¹⁰⁰

⁸⁷ A useful comparative table of who constitutes an insider in jurisdictions not considered in this Paper, including Hong Kong, Indonesia and Japan, is found in L Semaan, MA Freeman and MA Adams, “Is Insider Trading a Necessary Evil for Efficient Markets?: An International Comparative Analysis” (1999) 17 *Company and Securities Law Journal* 220 at 245: Definition of an “Insider”.

⁸⁸ Singapore (in its draft Securities and Futures Act 2001: its current law is based on the pre-1991 Australian legislation), Malaysia. Compare the UK Financial Services and Markets Act 2000 s 118(2)(a), which applies the civil market abuse provisions, including insider trading, to any person whose behaviour is based on confidential price-sensitive information.

⁸⁹ New Zealand.

⁹⁰ UK, South Africa, Germany (which refers to membership of the “managing organs” of the company), Canadian provincial securities legislation, New Zealand.

⁹¹ Germany.

⁹² Canadian provincial securities legislation, Germany, New Zealand.

⁹³ UK, South Africa, Canadian provincial securities legislation, New Zealand.

⁹⁴ UK, South Africa, Germany, New Zealand (substantial shareholders only).

⁹⁵ Germany.

⁹⁶ Canadian provincial securities legislation.

⁹⁷ Canadian provincial securities legislation.

⁹⁸ UK, South Africa, Germany.

⁹⁹ United States. In New Zealand, a person who does not have a connection with a corporation is a primary insider if the person obtains inside information in confidence either from the corporation itself or from a primary insider of that corporation.

¹⁰⁰ According to *Gower's Principles of Modern Company Law* (6th Edition, Sweet & Maxwell, 1997) at 465: “Although it is not entirely clear, it seems that the [by virtue of] test is simply a ‘but for’ test. If a junior employee happens to see inside information in the non-public part of the employer’s premises, he or she would be within the category of insider, even if the duties of the employment do not involve acquisition of that information. On the other hand, coming across

1.67 The employment category can be difficult to apply in practice:

“For example, does the barman at the local golf club become [a primary] insider if he overhears inside information being discussed by a couple of senior executives as he takes their order? ... It is unclear, however, whether there has to be a functional link between the individual’s employment, office or profession and the company or securities to which the information relates. If such a link is necessary, individuals such as the barman, the taxi driver or the worker, who gain inside information from snatches of overheard conversation would not be caught as primary insiders.”¹⁰¹

1.68 *Secondary insiders*. These are generally defined as persons who obtain inside information from a primary insider¹⁰² or another secondary insider.¹⁰³

1.69 The UK, South African and Canadian provisions do not require that the primary insider have intentionally communicated the inside information to a secondary insider. For instance, the Canadian legislation refers to a person “that learns of a material fact” from a primary or another secondary insider.¹⁰⁴ However, the secondary insider must be aware that the direct or indirect source of the information was a primary insider.

1.70 This awareness requirement can be difficult to meet, especially if the information came indirectly to the secondary insider via a chain of communication. To prove that a secondary insider knew that the ultimate source of the information was a primary insider could be difficult.

“To return to the [barman] example, the barman who overheard price-sensitive information being discussed in the golf club would be caught as a [secondary insider] [only] if it could be shown that he knew that his interlocutor was an inside source.

[More generally,] director A may pass on price-sensitive information to his brother B, who later tells his friends C and D. To insist that C and D should know the identity or the exact position of their indirect source of information will, in most cases, remove the prospect of successfully prosecuting sub-tippees who have received information from an intermediate tippee. It would have been

such information in a social context would not make the employee an insider, even though the information related to the worker’s employer.”

¹⁰¹ R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 289.

Similarly, C Estevan-Quesada, ‘The Implementation of the European Insider Dealing Directive’ (1999) 10 *European Business Law Review* 492 at 494 says: “One may consider the case of an employee who has no access to inside information in the exercise of his job but hears by chance during his working time an item of inside information. Shall he be considered as a primary insider? The answer is unclear. Apparently, he does not have access to the information by virtue of the exercise of his employment, since he did not receive the information in order to perform a particular task. On the other hand, one could argue that had he not been in the office he would have never got the information and that in this sense he had access to it by virtue of the exercise of his employment”.

¹⁰² UK, South Africa, United States, Canadian provincial securities legislation, New Zealand.

¹⁰³ Canadian provincial securities legislation.

¹⁰⁴ Ontario Securities Act s 76(5)(e).

better to cast the legislation in a manner that seeks to capture tippees solely on the basis of their knowledge of the specific and price-sensitive quality of the information they have received, rather than on their awareness of the identity or position of their intermediate or ultimate informant.”¹⁰⁵

1.71 Germany adopts a “person connection” approach for primary insiders, but in effect takes an “information connection” approach to secondary insiders. It defines secondary insiders as any persons who are not primary insiders but nevertheless have knowledge of inside information, regardless of how that information was obtained (legally or illegally), and without any requirement that secondary insiders be aware of the existence, identity or position of the original, or any intermediate, informant. The consequences are potentially far-reaching:

“The taxi driver [who overhears a conversation in the cab], the air hostess who hears a conversation between two businessmen while serving them a meal during the flight, the nosy cleaner who listens to his landlady speaking on the phone about the company she directs, the wife of the psychiatrist who listens to the conversation between her husband and one of his clients who is a stressed CEO of a big company, all fall within the definition of secondary insider.”¹⁰⁶

1.72 Under New Zealand law, the category of possible secondary insiders is limited to persons who are not more than two removes from a primary insider.

Advisory Committee view

1.73 The Australian “information connection” only approach applies insider trading laws to all persons who trade, or unlawfully disclose or procure, when aware of inside information. This contrasts with the “person connection” approach, which, for the most part, confines insiders to those informed persons who have some relevant connection, employment or fiduciary duty. From the perspective of market fairness and efficiency, it may be difficult to justify a restriction that would allow some persons armed with inside information lawfully to trade merely because they fall outside the “person connection” test.

1.74 The “information connection” only approach 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.

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

¹⁰⁵ R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 289-290, 294.

¹⁰⁶ C Estevan-Quesada, ‘The Implementation of the European Insider Dealing Directive’ (1999) 10 *European Business Law Review* 492 at 498.

Liabilities of insiders

The issue

1.75 Under Australian law, persons who are aware of inside information are prohibited from trading in affected securities, disclosing that information or procuring others to trade, unless there is a relevant exemption. Should these prohibitions be modified in light of comparable overseas provisions?

Trading

Australian law

1.76 Any person who is aware of inside information is prohibited from subscribing for, purchasing or selling affected securities, either as a principal or an agent, unless permitted under any statutory exemption.¹⁰⁷ It makes no difference whether they are transacting on their own or someone else's behalf or whether the affected securities are transferred to or from someone other than the insider.

1.77 *Non-trading.* An insider may lawfully use inside information for the purpose of refraining from trading or cancelling an order to trade, given that the prohibition only applies to trading.¹⁰⁸

Overseas law

1.78 Most of the jurisdictions discussed in this Paper prohibit primary or secondary insiders holding inside information from buying or selling securities, either as principals or agents for someone else.¹⁰⁹

1.79 The United States law is more restrictive. It prohibits informed primary insiders from trading only if they would thereby breach a duty under the fiduciary duty or misappropriation rationales. Therefore, trading is permitted with the consent, or (in misappropriation cases) the prior knowledge, of the person to whom that duty is owed.

1.80 The US law prohibits secondary insiders from trading only when they know, or should know, that:

- the information given to them is inside information
- the primary insider passed on that information in breach of the primary insider's fiduciary duty, and
- the primary insider has derived a direct or indirect personal benefit in so doing.

¹⁰⁷ s 1002G(2)(a). Some of these statutory exemptions are discussed elsewhere in this Paper.

¹⁰⁸ s 1002G(2)(a).

¹⁰⁹ UK, Germany, South Africa, Canadian provincial securities legislation, New Zealand (this jurisdiction imposes civil liability only), Singapore, Malaysia.

1.81 US law on insider trading during a takeover is somewhat broader, in that it does not have this fiduciary prerequisite for liability. Instead, it focuses on the mere possession of material non-public information. It prohibits any informed person (other than the bidder) from trading in target company securities if:

- the bidder has commenced or has taken a “substantial step” towards commencing the bid
- the informed person knows or has reason to know that the information was acquired directly or indirectly from the bidder, the target company or any officer of those entities, and
- the informed person knows or has reason to know that the information is non-public.

1.82 *Defences to trading.* The UK and South Africa provide primary and secondary insiders with a defence to prohibited trading where they can show that they “would have acted in the same manner even without the inside information”.

1.83 The UK also provides defences to primary and secondary insiders who can show that they:

- did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the inside information, or
- believed, on reasonable grounds, that the information had been or would be sufficiently disclosed to avoid prejudicing any participant in the dealings who did not have the information.

1.84 *Non-trading.* No jurisdiction discussed in this Paper prohibits primary and secondary insiders from refraining from trading (or cancelling prior orders to trade) on the basis of inside information.

Disclosing inside information

Australian law

1.85 Any person who is aware of inside information is prohibited from directly or indirectly disclosing confidential price-sensitive information concerning exchange-tradable¹¹⁰ securities to any other person who they know, or ought reasonably to know, would transact in the securities or procure some other person to

¹¹⁰ The prohibition applies where trading in securities is permitted on an exchange, even where on-market trading has been suspended by the exchange or prohibited by ASIC: s 1002D(1). The disclosure prohibition is the only instance where the Australian insider trading provisions are limited to exchange-tradeable securities. This follows the recommendation of the Griffiths Report, which argued that restrictions on disclosing inside information are not necessary for proprietary companies, whose shareholders are generally better informed and have greater access to material information regarding their companies than shareholders of listed companies. Also, many proprietary companies have restrictions on the transfer of shares: *Fair Shares for All*, paras 4.8.1-4.8.7 and Recommendation 8.

transact.¹¹¹ There are various statutory exceptions for certain disclosures, such as to underwriters¹¹² or pursuant to a legal requirement.¹¹³

1.86 *Non-trading.* The disclosure prohibition only applies where there is an actual or reasonable expectation that the recipient (or some other person) will transact in the affected securities.¹¹⁴ A person who discloses inside information with the clear purpose and a reasonable expectation of discouraging persons from trading may fall outside the prohibition.

Overseas law

1.87 Most of the jurisdictions discussed in this Paper prohibit primary or secondary insiders from disclosing any inside information of which they are aware to another person.¹¹⁵ Liability does not depend on the insider having received any financial or other reward for this disclosure.

1.88 The US law has different elements. Primary and secondary insiders are liable for disclosing any inside information to recipients only where that disclosure breaches a fiduciary or like duty owed by the disclosing person and the disclosure is made for that person's direct or indirect personal benefit. However, in the takeover context, these restrictions do not apply. Any person (other than the bidder) is liable for disclosing inside information where it is reasonably foreseeable that the recipient will trade. There is an exception for any communications made in good faith to the officers, directors, agents, advisers or employees of the bidder or target company in connection with conducting the bid.

1.89 *Defences to disclosure.* Some jurisdictions provide primary and secondary insiders with defences to disclosing inside information where they can show that:

- the disclosure took place in the proper performance of the functions of the primary or secondary insider's employment, office or profession.¹¹⁶ In South Africa, however, it must also be established that the insider, at the same time, disclosed that the information was inside information (thereby putting the recipient on notice). Also, the UK civil regime, except in certain instances (for instance, disclosures to employees or professional advisers to enable them to perform their functions), requires that any lawful disclosure of inside information should be accompanied by a statement indicating that the information is inside information and that the recipient should not trade until after the information has been made generally available¹¹⁷

¹¹¹ s 1002G(3).

¹¹² s 1002J.

¹¹³ s 1002L. This would cover, for instance, communication of inside information to ASIC or an exchange, pursuant to a legal requirement.

¹¹⁴ s 1002G(3).

¹¹⁵ UK, Germany, South Africa, Canadian provincial securities legislation, Singapore, Malaysia. The German insider trading legislation does not deal directly with secondary insiders disclosing inside information. However, German law may have this prohibition on secondary insiders by virtue of its aiding and abetting offences.

¹¹⁶ UK, South Africa, Canadian provincial securities legislation (this legislation refers to the disclosure being "in the necessary course" of the person's business).

¹¹⁷ Financial Services Authority Code of Market Conduct April 2001, Annex B, paras 1.8.5 & 1.8.6.

- the insider did not expect the recipient (or any other person) to trade because of the disclosure.¹¹⁸ This defence would, for instance, protect insiders who confide confidential information to another person, not as part of the proper performance of their official functions, but for reasons unrelated to trading in those securities.

1.90 The UK also provides a defence to primary and secondary insiders disclosing inside information who can show that, although they expected that the recipient would trade, they did not expect that any such trading would result in a profit, or avoidance of a loss, attributable to that information.

1.91 Germany makes it an element of the offence that any disclosure of inside information must have taken place without lawful authority. Otherwise, that jurisdiction, unlike the UK, has no statutory defences to the disclosure prohibition.

1.92 *Non-trading.* The US law effectively does not prohibit disclosures of inside information for the purpose of non-trading. The UK and some other jurisdictions also, in effect, permit primary and secondary insiders to disclose inside information where those insiders intend to discourage the recipient from trading.¹¹⁹ By contrast, primary insiders under the German legislation are liable for disclosing inside information without authority (whether or not they intend or suspect that the recipient would trade in the relevant securities, or whether the recipient does in fact trade). However, it appears that secondary insiders may be liable under German law for unlawfully disclosing inside information only if the recipient in fact trades.

Procuring trading

Australian law

1.93 *Liability of insiders.* Any person who is aware of inside information is liable for procuring another person to trade in affected securities, unless a statutory exemption or defence applies.¹²⁰

1.94 The expression “procure” is widely defined to include inciting, inducing or encouraging an act or omission by another person.¹²¹

1.95 The insider need not disclose the inside information to the person procured, or even indicate that the insider is aware of any price-sensitive information. Also, it is not necessary to establish that the person who is procured transacted in the affected securities. Mere encouragement to do so may suffice. Likewise, the motivation for

¹¹⁸ UK, South Africa, New Zealand. The South African defence requires that the insider’s belief be reasonable. New Zealand imposes civil liability for disclosure only if the person disclosing knows or believes that the recipient will buy or sell affected securities or that the recipient will advise or encourage a third person to buy or sell those securities.

By contrast, under the Ontario Securities Act, it is not necessary for the recipient to have traded on the information, or for the primary or secondary insider to have expected the recipient to so trade. Unauthorised disclosure alone constitutes an offence.

¹¹⁹ UK, South Africa, New Zealand have the defence that the insider did not expect the recipient (or any other person) to trade because of the disclosure.

¹²⁰ s 1002G(2)(b).

¹²¹ s 1002D(2).

procuring is irrelevant, for instance that the insider believed that the transactions in the particular securities would balance the long-term securities portfolio of the person procured.

1.96 *Liability of persons procured.* Any persons procured by an insider would be liable for insider trading only if, when they dealt in the affected securities, they also possessed some inside information, thereby themselves becoming insiders. The question remains, however, whether a person who was merely advised by an insider to trade in particular securities, unsupported by any information, would be prohibited from trading. This may depend on the knowledge that the person procured could reasonably expect the insider to have about those securities.¹²² In any event, where the insider and the person procured are acting in concert, the person procured could be liable for aiding and abetting the procuring breach by the insider.

1.97 *Non-trading.* An insider may lawfully use inside information for the purpose of procuring another person not to trade or to cancel an order to trade, given that the procuring prohibition only applies to inciting, inducing or encouraging a person to trade.¹²³

Overseas law

1.98 *Liability of insiders.* Various jurisdictions prohibit primary or secondary insiders who hold inside information from:

- procuring another person to buy or sell affected securities or
- encouraging or recommending another person to deal in affected securities.¹²⁴

1.99 In no jurisdiction is it necessary that any procuring or encouraging be successful, nor does it make any difference whether the procurer acted gratuitously or for personal gain. However, in the UK, but not the other jurisdictions, primary or secondary insiders are liable only if they know, or have reasonable cause to believe, that the other person will so deal.

1.100 The US law is more restrictive. Primary and secondary insiders who are aware of inside information are liable for recommending or encouraging trading by a recipient in affected securities only where they breach the same fiduciary duty and direct or indirect personal benefit prerequisites that apply to disclosing inside information (see para 1.88).

1.101 *Liability of persons procured.* The person procured or encouraged to deal by a primary or secondary insider would be guilty of insider trading under the various

¹²² See further para 2.57 on relevant US case law.

¹²³ See s 1002G(2)(b).

¹²⁴ UK, Germany, South Africa, New Zealand. The German insider trading legislation does not deal directly with secondary insiders procuring, encouraging or recommending. However, German law may have this prohibition on secondary insiders by virtue of its aiding and abetting offences. New Zealand imposes civil liability for advising or encouraging a second person to buy or sell affected securities or for advising or encouraging that second person to advise or encourage a third person to buy or sell those securities.

overseas laws only if the person procured satisfied the prerequisites for being a secondary insider, including that the person was aware of the inside information and committed the elements of the trading offence. One question is whether a person who is merely advised by an insider to trade in particular securities, unsupported by any information, holds inside information. Some US case law suggests that the mere advice to the recipient may constitute inside information, depending on the knowledge that the recipient could reasonably expect the insider to have about those securities.¹²⁵ In any event, where the insider and the person procured are acting in concert, the person procured could be liable for aiding and abetting the procuring breach by the insider.

1.102 *Defences to procuring.* The UK and South Africa provide primary and secondary insiders holding inside information with a defence to procuring or encouraging trading in affected securities where the insiders can show that they “would have acted in the same manner even without the inside information”.

1.103 The UK also provides a defence to those primary and secondary insiders who can show that they:

- did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the inside information, or
- believed, on reasonable grounds, that the information had been or would be sufficiently disclosed to avoid prejudicing any participant in the dealings who did not have the information.

1.104 *Non-trading.* Most of the jurisdictions examined in this Paper do not prohibit informed primary or secondary insiders from procuring other persons not to trade in affected securities. By contrast, South Africa imposes liability on any insider holding inside information who either “encourages or causes another person to deal or discourages or stops another person from dealing” in the affected securities.

Advisory Committee view

1.105 Various specific issues arising from the trading, disclosing and procuring prohibitions are discussed in Chapter 2.

1.106 The Committee here seeks views on whether the Australian law should adopt any of the following principles that have been applied in some overseas jurisdictions:

- *disclosing:* prohibiting any person holding inside information from disclosing that information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade (paras 1.86, 1.92)
- *disclosing:* requiring a person lawfully disclosing inside information to inform the recipient that the information is inside information (either under the UK civil or the South African principles) (para 1.89)

¹²⁵ See further para 2.57.

- *procuring*: imposing liability on persons holding inside information if they “discourage or stop” another person from dealing in affected securities (para 1.104).

1.107 The Committee notes the manifest difficulties of proof where an insider’s actions or disclosures result in non-trading. Also, if non-trading were included, the civil liability regime would need to be reviewed, given its current focus on the profits made or losses avoided through actual trading.

Issue 5. Should the insider trading legislation:

- prohibit any person holding inside information from disclosing that information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade
- require a person lawfully disclosing inside information to inform the recipient that the information is inside information
- impose liability on persons holding inside information if they “discourage or stop” another person from dealing in affected securities?

Chapter 2

Details of regulation

This Chapter raises a range of matters that affect the structure and operation of the Australian insider trading laws. It includes proposals to reform the concept of generally available information, adopt the principles in SEC Rule 10b5-1 and clarify the insider trading laws in the context of options, trading through intermediaries and takeovers. The Chapter also considers whether the current external administration, and some of the underwriting, exemptions are justified and whether derivative civil liability should be introduced.

Information covered

Generally available information

The issue

2.1 The insider trading laws seek to prohibit persons who are aware of any price-sensitive information that is not generally available from transacting, disclosing or procuring in relation to relevant securities. The distinction between what is and what is not generally available information is therefore crucial to the working of the legislation. Should the current tests of generally available information be reformulated?

Australian law

2.2 The Corporations Law has two alternative tests for determining what information is generally available (and can therefore lawfully be used in trading):

- *publishable information*
- *readily observable matter*.

Publishable information

2.3 This is information that “has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information”.¹²⁶

2.4 The publishable information test applies differently to:

- *uninformed persons*, that is, persons who become aware of price-sensitive information affecting particular securities “solely as a result of the information having been made known ... in a manner that would, or would

¹²⁶ s 1002B(2)(b).

be likely to, bring it to the attention of persons who commonly invest” in that kind of securities,¹²⁷ and

- *informed persons*, that is, persons who become aware of inside information earlier, or through a different means, than uninformed persons.

2.5 Uninformed persons can trade immediately they become aware of any publishable information. No dissemination period is required.¹²⁸ This protects a previously uninformed diligent investor or market analyst who responds immediately to information that is in the process of being publicly disseminated.

2.6 Informed persons can trade on publishable information only after a reasonable dissemination period has elapsed.¹²⁹ The Griffiths Report explained the reason for this mandatory delay:

“It is clearly incompatible with the intent of the legislation if an [informed person] gains an advantage from the dissemination of information before the market has had a reasonable time to absorb that information”.¹³⁰

2.7 Disclosure to a small group of investors only would not satisfy the dissemination requirement.¹³¹ The legislation does not prescribe a reasonable dissemination period. This would be determined by market practices.¹³²

Readily observable matter

2.8 The Griffiths Report did not refer to any readily observable matter test.

2.9 Nevertheless, this test was subsequently introduced as an amendment to an earlier draft of the 1991 insider trading amendments, for the following reasons.

“Concern was expressed that in consequence of the adoption of this definition [that is, the publishable information test] in the exposure draft, information directly observable in the public arena would not be regarded as generally available, as it had not been ‘made known’. It was considered that a person could be liable for insider trading where he/she traded in securities on the basis

¹²⁷ s 1002B(2)(b)(i).

¹²⁸ This result arises from the interaction of various provisions. Under s 1002T(2)(a), there is a defence “if the Court is satisfied that the information came into the first-mentioned person’s possession *solely* as a result of the information having been made known as mentioned in subparagraph 1002B(2)(b)(i)”. (A similar defence applies in civil litigation: s 1013(7).) This defence does not require that s 1002B(2)(b)(ii) be satisfied, namely that “since it was so made known, a reasonable period for it to be disseminated among such persons has elapsed”.

¹²⁹ s 1002B(2)(b)(i) and (ii) both apply.

¹³⁰ *Fair Shares for All*, para 4.5.7.

¹³¹ The Explanatory Memorandum to the 1991 amendments states that “it would not be sufficient for information to be released to a small sector of the investors who commonly invest in securities ... [the] information must be made known to a cross-section of the investors who commonly invest in the securities” (para 328).

¹³² For instance, the ASX has a 10 minute trading halt following its release of material information that has been given to the Exchange.

of, for example, an observation that the body corporate had excess stocks [eg of cars] in a yard. This was not the intention of the provisions.”¹³³

2.10 The legislation does not define a “readily observable matter”.

2.11 Informed and uninformed persons can trade immediately on the basis of readily observable matter.¹³⁴ Unlike the publishable information test, there is no reasonable dissemination period for informed persons.

Overseas law

2.12 The UK and South African provisions have concepts somewhat analogous to readily observable matter. Information shall be deemed to be made public (the equivalent of being generally available) if it can be readily acquired by those likely to deal in any securities to which the information relates or any securities of an issuer to which the information relates.¹³⁵ In addition, information may, but not necessarily will, be regarded as being public “even though ... it can be acquired only by observation”.¹³⁶ Likewise, the proposed UK civil insider trading provisions provide that information is treated as generally available if it can be obtained by such means as observation.¹³⁷

2.13 The draft Singapore legislation proposes to adopt a readily observable matter test, based on the current Australian provisions.¹³⁸ By contrast, the Malaysian definition of generally available information, which broadly follows the Australian definition, does not include “readily observable matter”.

Australian case law on readily observable matter

2.14 The meaning of the term “readily observable matter” has been considered in two related cases, *R v Kruse*¹³⁹ and *R v Firns*.¹⁴⁰

The facts in both cases

2.15 The relevant facts were that the value of a particular Australian listed company’s shares would be materially affected by the outcome of an appeal in the Supreme Court of Papua New Guinea. Both defendants were officers of the appellant company. They became aware that the judgment would be handed down at 9.30 am on a particular Friday by notification by the Supreme Court to the parties the previous

¹³³ Explanatory Memorandum para 326.

¹³⁴ s 1002B(2)(a). This defence applies to criminal and civil liability, given that readily observable matter constitutes generally available information, and is therefore outside the general prohibition in s 1002G.

¹³⁵ UK Criminal Justice Act s 58(2)(c), South African Insider Trading Act 1998 s 3(1)(c).

¹³⁶ UK Criminal Justice Act s 58(3)(c), South African Insider Trading Act 1998 s 3(2)(a).

¹³⁷ Financial Services and Markets Act 2000 s 118(7). FSA Code of Market Conduct April 2001, Annex B para 1.4.8 refers to the example of a train passing a burning factory and a passenger calling his broker using his mobile telephone to sell shares in the company that owns the factory.

¹³⁸ Draft Securities and Futures Act 2001 s 204(a).

¹³⁹ New South Wales District Court, December 1999.

¹⁴⁰ First instance: New South Wales District Court, November 1999. On appeal: New South Wales Court of Criminal Appeal [2001] NSWCCA 191.

evening. The Supreme Court decision on that Friday morning found in favour of the company.

2.16 One defendant attended the Papua New Guinea Court and immediately the decision was known telephoned his broker in Australia with instructions to purchase the company's shares in Australia. The other defendant remained in Australia and purchased the company's shares in Australia immediately after being informed, by telephone, of the successful appeal. All these on-market purchases occurred on that Friday morning within approximately an hour of the Court's decision being handed down.

2.17 The company notified the Australian Stock Exchange the following Monday afternoon of the Court's decision and its positive consequences for the company. Also, reports of the judgment first appeared in the Papua New Guinea media on that Monday and in the Australian media on Tuesday. The two defendants subsequently sold the shares they had purchased at a profit.

2.18 Both defendants were charged with breach of the Australian insider trading provisions and were given separate trials. The alleged inside information was the content of the Papua New Guinea Court judgment. Both defendants argued that this judgment was a readily observable matter under the Australian law and therefore no dissemination period was required before they purchased the securities.

R v Kruse

2.19 In this case, the defendant was in the Papua New Guinea Court when the decision was handed down. The New South Wales District Court ruled that "readily observable matter" was not limited to information the source of which was in Australia. Therefore, a Papua New Guinea Court decision was a readily observable matter:

"the facts must be directly observable in a public arena, but that public arena need not be confined to this country or to any State in this country. ... [However, a] matter cannot be readily observable if it happens in some remote area in a situation where there is no dissemination of information".

2.20 The Court directed the jury to acquit the defendant on the readily observable matter ground.

R v Firms

2.21 In this case, the defendant was in Australia when the decision was handed down in the Papua New Guinea Supreme Court. The New South Wales District Court, at first instance, held that the readily observable matter element was confined to matters occurring within Australia. The defendant was convicted. The New South Wales Court of Criminal Appeal, by majority, quashed this conviction, ruling that the announcement of a judgment in an open Papua New Guinea court was a readily observable matter under the Australian legislation and the defendant did not breach the insider trading provisions by purchasing shares immediately thereafter.

2.22 Mason P, in the majority Court of Criminal Appeal judgment, described the concept of readily observable matter as “opaque”. His Honour ruled that readily observable matters are not confined to things that can only be perceived by vision. Also, given modern telecommunication methods, including telephone, fax and Email, readily observable matters are not limited to things that can be perceived in Australia. A large proportion of investors in Australian companies are non-Australians and the insider trading provisions should not be confined to protecting the interests of resident Australians only. Furthermore, the Papua New Guinea judgment was readily observable even though some time would inevitably elapse before the profession generally learned about it and absorbed its effect. Given this, the defendant had not breached the legislation by trading within approximately an hour of that judgment being handed down.

2.23 The dissenting Court of Criminal Appeal judge in *R v Firms* took the view that a matter must be readily observable to the investing public at large, which must at least include the Australian public. Also, the reference to “readily observable” matter would not cover any matters that could only be discovered by members of the public meticulously searching for them.

The effect of the cases

2.24 One implication of these decisions is that corporate officers who become aware of any readily observable matter affecting their company may trade immediately in the company’s securities, before the market is advised of that matter (for instance, through a press release or a continuous disclosure notice) or the information otherwise becomes generally available.

Advisory Committee view

2.25 The Court of Criminal Appeal in *R v Firms* referred to the “conflicting goals embedded in the essentially two-pronged definition of ‘information generally available’”.¹⁴¹

2.26 The conflicts arise from:

- the lack of any public dissemination period requirement for readily observable matter, even for persons closely associated with the company whose securities are traded
- the uncertain application of the term “readily observable matter”.

2.27 In the Advisory Committee’s view, these problems could best be remedied by:

- giving priority to the publishable information test by confining the readily observable matter test to anything not capable of falling within the publishable information test
- clarifying the application of the publishable information test

¹⁴¹ [2001] NSWCCA 191 para 58.

- extending the circumstances where a reasonable dissemination period is required under that test
- reviewing the meaning of the readily observable matter test.

Giving priority to the publishable information test

2.28 The Explanatory Memorandum to the 1991 legislation indicated that the readily observable matter test was included as an amendment to the draft legislation to overcome concerns that the “made known” requirement in the publishable information test (see para 2.3) would not cover matters that, of themselves, are not means of propagating information. In the Advisory Committee’s view, the readily observable matter test should have been included only to cover information not capable of falling within the publishable information test. However, the provision was drafted to give equal, if not greater, prominence to the readily observable matter test.

2.29 The legislation should be redrafted to provide that any information that can satisfy the publishable information test should be regulated under that test. The readily observable matter test should only apply to any residual matter.

Clarifying the application of the publishable information test

2.30 The application of the “made known” requirement in the publishable information test may be unclear. Consider the following two examples:

- a judgment in open court in a domestic or foreign jurisdiction materially affecting an Australian listed company
- a major catastrophe such as a natural or man-made disaster occurring on a site owned by an Australian publicly listed company and located in Australia or overseas (for instance, a burning factory or a polluting oil spill).

2.31 Arguably, a judgment given in open court would fall within the existing publishable information test, as “it has been made known in a manner that would, or would be likely to, bring it to the attention of” the investing public. Less certain is whether the mere occurrence of a catastrophe would satisfy this “made known” requirement, given that a catastrophe, unlike a judgment read out in open court, is not of itself a means of propagating information. However, the catastrophe, as with the judgment, would be likely to become known to the market generally (for instance, through media reports or the continuous disclosure requirements), and therefore, in principle, should be included within the publishable information test.

2.32 To overcome any uncertainty, the publishable information test should be amended to state that the “made known” requirement covers any information, matter or event whose existence or price-sensitive implications will, or will be likely to, come to the attention of the investing public either of itself or through some other means. This revised “made known” requirement should also cover any price-sensitive information that would or would be likely to come to the attention of the investing public but for a lawful exemption from disclosure, such as under any of the exceptions to the continuous disclosure requirement in ASX Listing Rule 3.1.

2.33 Applying the revised “made known” requirement, a catastrophe, as well as a court judgment, would be publishable information. By contrast, the excess stock example in the Explanatory Memorandum would not be publishable information, if that fact, alone, would not be likely to come to the attention of the investing public.

Extending the circumstances where a reasonable dissemination period is required under the publishable information test

2.34 As previously indicated (paras 2.4-2.7), only informed persons need wait a reasonable period for the dissemination of publishable information before they can lawfully trade.

2.35 The Griffiths Report, in proposing this reasonable dissemination period, considered that it would be incompatible with the intention of the insider trading legislation if informed persons could gain a trading advantage before the market had a reasonable opportunity to absorb that information.¹⁴² Likewise, the Explanatory Memorandum to the 1991 amendments pointed out that the reasonable dissemination period “is designed to prevent an insider, who is aware of information prior to its release, getting an unfair head start on other market participants”.¹⁴³

2.36 Directors or other officers of a company that is materially affected, say, by a court judgment or a natural or man-made disaster could argue that they are uninformed persons, as they became aware of the inside information “solely as a result of the information having been made known ... in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest” in their company’s securities. In that case, they could trade immediately, without waiting for a reasonable dissemination period.¹⁴⁴

2.37 The market fairness and market efficiency goals of insider trading laws could be perceived to be severely compromised if persons who are closely associated with a company and become aware of publishable information affecting that company could trade in the company’s securities before the market had an opportunity to be informed.

2.38 To overcome this possibility, the Advisory Committee proposes that the reasonable dissemination period requirement in the publishable information test be extended beyond informed persons to any other person “connected” with a company.

2.39 The following could be connected persons:

- any director or executive officer of the company or a related company¹⁴⁵

¹⁴² *Fair Shares for All* para 4.5.7.

¹⁴³ Explanatory Memorandum para 328.

¹⁴⁴ Currently, it is a defence to a criminal prosecution “if the Court is satisfied that the information came into the [defendant’s] possession solely as a result of the information having been *made known* ... in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities” of that kind: ss 1002T(2)(a), 1002B(2)(b)(i).

¹⁴⁵ s 9 definitions of “director”, “executive officer”.

- any other person whose relationship with the company may reasonably be expected to provide that person with access to any undisclosed price-sensitive information about that company.

2.40 Connected persons who become aware of any publishable information affecting any of the securities of their companies would be subject to the trading, disclosing and procuring prohibitions in relation to those securities until a reasonable period for dissemination of that information has elapsed. This rule would reflect the primacy of the goal of a fully informed market over the trading opportunities for individuals closely connected with particular companies.

Reviewing the meaning of the readily observable matter test

2.41 The decisions in *R v Firms* and *R v Kruse* do not resolve many of the outstanding questions about what constitutes readily observable matter. Rather, as indicated by Mason P in *R v Firms*,¹⁴⁶ they leave open questions such as:

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

though the need to clarify these matters may be less pressing, given the proposal to give priority to the publishable information test.

2.42 *Observable to whom.* One commentator has raised the following questions:

“One may ask, readily observable to whom? Suppose the excess stocks [as referred to in the Explanatory Memorandum], instead of being in a yard, were inside a building to whom lawful entrance was permitted only to staff and those having business dealings? Would the excess stocks then be ‘readily observable’? What about the confidential memorandum picked up in the street? It is certainly ‘readily observable’ to the person who picked it up and those to whom he shows it. What about the careless conversation in a lift? It is certainly ‘readily observable’ by the ears of the passengers in the lift who are able to hear it. In either case, the information is not in the public domain; but is it ‘generally available’ by virtue of being ‘readily observable’?”.¹⁴⁷

2.43 *How observable.* Does the notion of readily observable matter include a matter that is observable only with technological assistance? One commentator has raised the following example.

“Assume A discovers by lawful means the existence of a mineral deposit under land owned by B Ltd, a listed company. Specifically, A analysed the publicly available reports on the land and then flew over the land in an aeroplane fitted to detect magnetic anomalies. A buys shares in B Ltd, without disclosing the

¹⁴⁶ para 64.

¹⁴⁷ T Bostock, “Australia’s new insider trading laws” (1992) 10 *Company and Securities Law Journal* 165 at 171.

information. Under the Corporations Law, the question of liability would turn on whether the information about the deposit on B's land was 'readily observable'. On a strict interpretation of the words, the information would probably not be readily observable, as a person could not just walk onto the land and observe the deposit. It would not be directly observable in a public arena."¹⁴⁸

2.44 The Court in *R v Firms* raised, but did not resolve, the question of whether readily observable matter is limited to things perceptible by the unaided human senses or, if not, what technological aids would be permissible.

2.45 What if information is only available in a foreign language? Would the level of access to suitable means for translating the language make any difference?

2.46 *Where observable*. One commentator supports the view, as now reflected in *R v Kruse* and *R v Firms*, that the readily observable matter test should not be confined to matters readily observable in Australia. Otherwise:

"If foreign investors legitimately obtain information that is not generally available in Australia from an offshore source and trade upon that information, then they are prima facie insiders and liable to prosecution as the readily observable matter test would not assist them ... Such overreach seems wrong in principle".¹⁴⁹

2.47 This commentator suggests that the locality test of readily observable matter should be linked to the elements of the offence. Therefore:

"if the relevant acts and omissions are alleged to occur within Australia, the information must be readily observable matter in Australia. If the acts and omissions are alleged to occur outside Australia, the information must be readily observable matter in the offshore jurisdiction".¹⁵⁰

2.48 This approach has various difficulties. The first is where relevant acts occur in more than one jurisdiction. For instance, assume that a person travels to a foreign jurisdiction where a "readily observable matter" subsequently takes place and that person immediately contacts a broker in Australia and arranges to trade without delay in the affected securities on an Australian exchange. One relevant act occurs offshore (the instructions to trade), while another relevant act occurs in Australia (the actual trading). To which jurisdiction should the proposed locality test apply? If the answer is the foreign jurisdiction, the test would exonerate a person who travelled to that jurisdiction, whereas a person who remained in Australia but was informed of the offshore "readily observable matter" could not trade until the information was otherwise generally available, given that it was not readily observable in Australia. This difference in result seems difficult to justify.

¹⁴⁸ M Gething, "Insider trading enforcement: where are we now and where do we go from here?" (1998) 16 *Company and Securities Law Journal* 607 at 613.

¹⁴⁹ G Walker, "Insider Trading in Australia: When is Information Generally Available?" (2000) 18 *Company and Securities Law Journal* 213 at 214.

¹⁵⁰ *Id* at 217.

2.49 An alternative policy option, similar to the approach of the dissenting Court of Criminal Appeal judge in *R v Firms*, would be to confine any readily observable matter test to material that is readily observable by persons in Australia who commonly invest in securities of that kind in Australia. Its purpose would be to better ensure that Australian market participants have an equal opportunity to learn of the information before trading is permitted. However, this raises the issue of fairness for offshore participants in the Australian market.

2.50 Would information posted on a corporate intranet site or anonymously in a chatroom on the Internet be a readily observable matter?¹⁵¹

Issue 6. Should the test of generally available information:

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

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

Level of precision of the inside information

The issue

2.51 How precise should information be before it becomes inside information?

Australian law

2.52 The insider trading prohibition applies to any information that is materially price-sensitive, namely:

“a reasonable person would expect it to have a material effect on the price or value of securities of a body corporate”.¹⁵²

2.53 The legislation does not have an additional requirement of specificity. Inside information can include:

“matters of supposition and other matters that are insufficiently definite to warrant being made known to the public and matters relating to the intentions, or likely intentions, of a person”.¹⁵³

¹⁵¹ The New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (November 2000) at paras 92-95 concluded that information posted on a computer system that could, for approximately 30 minutes, be accessed by about 200 people, all of whom were employees of the company whose securities were traded or associated service providers of that company, was not publicly available.

¹⁵² s 1002G(1)(a).

¹⁵³ s 1002A(1) definition of “information”.

2.54 This definition avoids the narrow concept of specificity found in earlier insider trading legislation, where it was held that:

“specific information ... connotes not merely that it is precisely definable but that its entire content can be precisely and unequivocally expressed and discerned.”¹⁵⁴

Overseas law

2.55 Most jurisdictions examined in this Paper do not require that inside information be precise. However, two jurisdictions, the UK and South Africa, require that inside information be “specific or precise”. This serves to exclude rumours, suspicions, conjecture or speculation from the ambit of inside information.¹⁵⁵

2.56 Information can be specific, though not precise, for instance, knowledge that a particular person proposes to launch a takeover bid for a particular company or that a company’s profits are in excess of expectation, without any precise information about the details of the bid or the amount of profit.¹⁵⁶

2.57 Under US law, inside information is not limited to verifiable facts. It includes:

- any information that might affect the value of the securities in question, such as plans or proposals or projections and estimates regarding an entity’s earnings and liabilities
- information that contradicts or calls into question prior assumptions about a company that were held by investors generally
- mere recommendations from credible sources. In one case, the court held that the mere statement by a company executive that “events were occurring” at that company that would result in an increase in the market price of the company’s shares and that this information was not public, together with a recommendation to buy the shares, constituted inside information¹⁵⁷
- a course of conduct. In one case, a broker observed that one of his firm’s clients consistently bought shares in advance of their nomination as “stock of the week” in a market influential publication. The broker set up a programme of parallel trading of whatever shares the client gave instructions to purchase. The broker’s own trading was deemed to amount to insider trading.¹⁵⁸

¹⁵⁴ *Ryan v Triguboff* (1976) 1 ALCR 337 at 344. This case dealt with the insider trading provisions under the Securities Industry Act 1970 (NSW).

¹⁵⁵ P Osode, ‘The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill?’ (2000) 44 *Journal of African Law* 239 at 243.

¹⁵⁶ M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 97-98; B Rider in the CCH UK Financial Services Reporter (looseleaf) §42-140 at 43,403.

¹⁵⁷ *SEC v Trikilis* Federal Securities Law Reporter (CCH) [1992 Transfer Binder] §97,015.

¹⁵⁸ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §11.04[1] at 11-22.

2.58 Inside information under US law can also include a “mosaic” of discrete pieces of information, none of which, in isolation, is precise or conclusive. For instance, in one case,¹⁵⁹ the defendant was the husband of an administrative officer of company A. That company was in the process of secretly formulating a takeover bid for company B. At a social function, the defendant heard some employees of company A talking about how interesting it was to be working on “an acquisition”. Then, using his position as an electrician in the offices of company A, the defendant eavesdropped in an effort to ascertain the intended target. He overheard an officer of company A on the phone discussing company C, which he ascertained through his own research was a subsidiary of company B. He also learned of the travel plans of various officers of company A to the city where company B had its headquarters, as well as other small but helpful bits of information in conversations with his wife (who was unaware that company B was a takeover target). Gradually he became convinced that company B was the stock to buy. The Court held that he was in possession of inside information.

2.59 The definition of information in the Malaysian legislation and the proposed Singaporean legislation adopts the Australian definition of information, but goes beyond it to make it clear that information also covers such things as:

- matters relating to negotiations or proposals with respect to commercial dealings or dealings in securities and
- matters relating to the future.

Advisory Committee view

2.60 The Advisory Committee does not support any statutory requirement that the information be specific or precise. It notes the argument that this requirement could ensure that mere rumour, suspicion, conjecture or speculation does not constitute inside information. However, the Australian legislation applies only to information that a reasonable person would expect to be materially price-sensitive. Also, it would be very difficult to successfully prosecute a person without being able to identify some particular inside information. To introduce an additional “specific or precise” requirement could unduly narrow the application of the legislation and create artificial distinctions between what does and what does not constitute information.

2.61 The Committee sees no pressing need for an extension of the definition of information, as found in the Singapore and Malaysian legislation.

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

Insider trading and continuous disclosure

The issue

2.62 Do the insider trading and continuous disclosure laws satisfactorily complement each other?

¹⁵⁹ *SEC v Falbo* 14 F.Supp. 2d 508 (1998).

Australian law

2.63 Continuous disclosure for all disclosing entities was introduced in 1994, after the current insider trading provisions came into force.¹⁶⁰ These disclosure provisions were designed to improve *market fairness* and *market efficiency* by requiring disclosing entities to publish price-sensitive information promptly, thereby assisting all investors to make properly informed decisions about the allocation of their investment funds. Timely disclosure was also intended to help reduce the opportunities for insider trading as well as counter the creation of false markets or the distortion of markets through dissemination of rumours or false information.¹⁶¹

2.64 The continuous disclosure and insider trading provisions both apply to any information that is not generally available and that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of particular securities.¹⁶² However, the continuous disclosure provisions have various exemptions not found in the insider trading provisions.¹⁶³ This difference seeks to reflect differing obligations: continuous disclosure involves an obligation to disclose information to the market, whereas insider trading involves an obligation to refrain from trading when aware of the information. In summary:

- the definition of “information” in the insider trading provisions includes matters of supposition and other matters that are insufficiently definite to warrant being made known to the public.¹⁶⁴ Where this information is materially price-sensitive, an insider is precluded from transacting in affected securities. By contrast, these matters, and any information concerning an incomplete proposal or negotiation, are exempt from the

¹⁶⁰ ss 1001A-1001D, ASX Listing Rule 3.1. Disclosing entities are defined in s 111AC.

In addition to the continuous disclosure obligations, the ASX Listing Rules have specific disclosure obligations in relation to significant transactions, dividend announcements, communications from the Commissioner of Taxation disallowing deductions, options to acquire mining tenements, winding up applications or appointments of receivers etc.

¹⁶¹ Companies and Securities Advisory Committee, *Report on an Enhanced Statutory Disclosure System* (September 1991) at 7. ASIC has undertaken various initiatives to improve compliance with the continuous disclosure requirements: see further para 0.9. The ASX also has a surveillance programme for continuous disclosure compliance.

¹⁶² Continuous disclosure: ss 1001A(2), 1001B(1), ASX Listing Rule 3.1; insider trading: s 1002G(1). The term “generally available” information is defined in identical terms for continuous disclosure (s 1001C) and insider trading (s 1002B). Likewise, the concept of “material effect on price or value” is defined in identical terms for continuous disclosure (s 1001D) and insider trading (s 1002C).

¹⁶³ Under ASX Listing Rules 3.1.1-3.1.3, the ASX disclosure requirement does not apply for so long as each of the following conditions is satisfied:

- a reasonable person would not expect the information to be disclosed
- the information is confidential, and
- one or more of the following conditions apply:
 - (a) it would be a breach of the law to disclose the information
 - (b) the information concerns an incomplete proposal or negotiation
 - (c) the information comprises matters of supposition or is insufficiently definite to warrant disclosure
 - (d) the information is generated for the internal management purposes of the company, or
 - (e) the information is a trade secret.

¹⁶⁴ s 1002A(1) definition of “information”.

continuous disclosure requirements,¹⁶⁵ as release of this information could be misleading (given that it is uncertain or unsettled) or commercially damaging

- the continuous disclosure provisions have exemptions for information generated for the internal management purposes of a company and trade secrets, given their commercial sensitivity.¹⁶⁶ There are no equivalent exemptions under the insider trading provisions. Indeed, trading when aware of these matters should be covered by the insider trading law, provided that they are materially price-sensitive
- continuous disclosure only covers relevant information generated within, or otherwise known to, the disclosing entity. That entity cannot be obliged to disclose any information that is relevant to itself, but of which it is unaware.¹⁶⁷ By contrast, a person who is aware of inside information cannot avoid the insider trading provisions merely because that information is generated by some external source and is unknown to the entity whose securities are traded
- only information that is known (or ought reasonably to be known) by directors and executive officers of a company in the course of their duties is subject to continuous disclosure.¹⁶⁸ By contrast, bodies corporate are subject to the insider trading rules where any of their officers, not just executive officers, satisfies the information awareness test.¹⁶⁹ A body corporate in that situation can lawfully trade only if it has an effective Chinese Wall.¹⁷⁰

Overseas law

2.65 In various jurisdictions, the concept of inside information is broader than information to be disclosed under continuous disclosure. For instance, it has been argued that, under German law, profit forecasts or budget plans constitute inside information, but are not disclosable under German continuous disclosure requirements.¹⁷¹

Advisory Committee view

2.66 The insider trading provisions should continue to apply to information that, while materially price-sensitive, falls within one or more of the exemptions from the continuous disclosure requirements.

¹⁶⁵ ASX Listing Rule 3.1.3(b), (c).

¹⁶⁶ ASX Listing Rule 3.1.3(d), (e).

¹⁶⁷ For instance, entity A obtains reliable geological information that strongly indicates that there is a large and valuable mineral deposit on land owned by listed company B. Company B is required to disclose that information (if it satisfies the test in Listing Rule 3.1) under the continuous disclosure requirements only when it becomes aware of that information.

¹⁶⁸ ASX Listing Rule 19.12 definition of “aware”, s 9 definition of “executive officer”.

¹⁶⁹ s 1002E, s 9 definition of “officer”.

¹⁷⁰ s 1002M.

¹⁷¹ Inside information (*Insidertatsache*) is defined under Wertpapierhandelsgesetz §13(1). The continuous disclosure requirements are set out in §15. See further the comparative analysis between §13(1) and §15 by T Hickinbotham & C Vaupel in M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 133.

2.67 If insider trading were limited to information falling within the continuous disclosure requirements, a person with inside information that is exempt from the continuous disclosure provisions could trade to advantage, as the market would be uninformed. This could give the impression of a market being open to manipulation by those who can determine the timing and content of their market disclosures.

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

Research and analysis: mixing research and inside information

The issue

2.68 Market research and analysis are fundamental to ensuring an efficient market. However, research may involve gathering information that is not generally available. What tests should distinguish between research and analysis and inside information?

Australian law

2.69 There is a specific exemption for research and analysis that take the form of deductions, conclusions or inferences made or drawn from generally available information.¹⁷² By contrast, any deductions etc gleaned from non-generally available information, for instance, private discussions with company officers about particular matters concerning that company, or analysis of unpublished corporate documents (for instance, budgets), do not come within the statutory research and analysis exception and may constitute inside information if material and price-sensitive. Both the provider of that information and the recipient may be liable for any subsequent trading while the information remains confidential.

Overseas law

Europe and South Africa

2.70 The German legislation provides an exemption for research and analysis only if they are based entirely on publicly known information. That research and analysis can lawfully be used for trading, even if they could considerably affect the price of the securities.¹⁷³

2.71 The UK and South African statutes provide that information may be treated as having been made public (and therefore not being inside information) even though it can be acquired only by persons exercising diligence or expertise or by observation.¹⁷⁴ Unlike the German law, there is no express requirement in the UK or South African legislation that the diligence or expertise must be exercised only on publicly available information, though it may be illogical to characterise information gleaned by a researcher from confidential sources as having been made public.

¹⁷² s 1002B(3).

¹⁷³ Wertpapierhandelsgesetz §13(2).

¹⁷⁴ UK Criminal Justice Act s 58(3)(a), (c), South African Insider Trading Act 1998 s 3(2)(a).

2.72 The UK and South African provisions also provide a defence to persons who can show that they would have acted in the same manner even without the inside information.¹⁷⁵ This defence could apply to a person who, on the basis of research and analysis of publicly available information, decides to buy or sell certain securities, and subsequently, but prior to trading, obtains inside information that supports that previously reached decision.

United States

2.73 The US case law appears to be the most permissive. In the leading US decision, *Dirks v SEC*,¹⁷⁶ the Court held that an analyst who privately questioned corporate employees about rumours of possible fraudulent activities in the company, and then discussed his findings with some clients, who subsequently sold their securities in that company, did not breach the US insider trading rules. The Court ruled that the analyst had obtained material non-public information from diligent research. To prohibit this activity through the insider trading laws:

“could have an inhibiting influence on the role of market analysts, which ... is necessary to the preservation of a healthy market. It is commonplace for analysts to ‘ferret out and analyse information’ and this is often done by meeting with and questioning corporate officers and others who are insiders”.¹⁷⁷

Advisory Committee view

2.74 The Advisory Committee does not support the approach adopted in *Dirks v SEC*. Australian law already permits market analysts to act on deductions, conclusions and inferences drawn from generally available information. To grant a broader exemption may allow analysts to use inside information to trade by characterising that information as being acquired through research and analysis.

2.75 Rather, the principles in SEC Rule 10b5-1 (developed in another context) could be applied to persons who have reached irreversible trading decisions based on research and analysis of publicly available information before coming into possession of confidential price-sensitive information concerning those securities. Rule 10b5-1 permits persons to structure securities trading plans and strategies, to be implemented at a future time, provided that those persons had devised the plan before they became aware of any relevant price-sensitive information, and they had no discretion over the plan or strategy thereafter.

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

Research and analysis: trading before publishing one’s own research

The issue

¹⁷⁵ UK Criminal Justice Act s 53(1)(c), South African Insider Trading Act 1998 s 4(1)(b).

¹⁷⁶ 463 US 646 (1983).

¹⁷⁷ id at 658.

2.76 Persons conducting research into particular securities may seek to trade in those securities before publishing their research findings (and any recommendations), for instance, by buying [selling] securities in advance of releasing positive [negative] research results (and recommendations) concerning those securities.

2.77 Should these research results (and recommendations), if materially price-sensitive, constitute inside information, thereby prohibiting their authors from trading in affected securities before this information becomes generally available?

Australian law

2.78 Trading in affected securities by an entity prior to publication of its price-sensitive recommendations appears to constitute insider trading, except where there is an effective Chinese Wall between the research and trading personnel of the entity.¹⁷⁸ The inside information in this case is the research findings (and any recommendations), notwithstanding that they may be based on deductions, conclusions and inferences drawn from publicly available information. Also, the statutory exceptions for persons having knowledge of their own intentions or activities¹⁷⁹ only apply to their own transactions in securities, not to the content of any report that may influence trading by others.

Overseas law

2.79 A US court has convicted a journalist of insider trading where he dealt in securities in advance of the publication of his recommendations concerning those securities in his newspaper column.¹⁸⁰

2.80 There has also been a recent successful prosecution under the German insider trading law of a business journalist who purchased securities in advance of publishing his price-sensitive recommendations concerning those securities.¹⁸¹

Advisory Committee view

2.81 The argument for permitting authors of price-sensitive research reports to trade prior to publication of those reports is that research and analysis benefit

¹⁷⁸ ss 1002M, 1002N.

¹⁷⁹ ss 1002P, 1002Q, 1002R.

¹⁸⁰ In *United States v Carpenter* 791 F.2d 1024 (1986), a reporter for the *Wall Street Journal* traded in advance of recommendations in his newspaper column. The journalist was convicted of insider trading under the misappropriation theory, based on the finding that he had breached the Journal's policy prohibiting personal use of information produced or derived on behalf of the newspaper. The newspaper suffered reputational injury when the public became aware of that trading.

¹⁸¹ The Bundesaufsichtsamt für den Wertpapierhandel [Federal Supervisory Office for Securities Trading] 1999 *Annual Report* at 25 refers to a November 1999 decision of the regional Court of Frankfurt am Main, which ruled that a business journalist who purchased securities in advance of publishing his price-sensitive recommendations, and with the aim of benefiting from the resulting price gain, was liable for insider trading. The Court ruled that mental processes such as the intention to release a recommendation can represent inside information. Under the legislation, the business journalist would be prohibited from either purchasing affected securities in advance of the publication of his recommendation, or informing third parties in advance about what securities he would recommend.

financial markets. A prohibition on pre-publication trading may reduce the incentive for research.

2.82 The contrary argument is that any trading exemption could result in persons profiting through advance dealing in securities whose price is likely to be influenced by publication of their research findings and recommendations. This may undermine public confidence that the market is not open to manipulation.

2.83 Applying the insider trading provisions in this situation would not prevent corporate entities and partnerships from trading where there is an effective Chinese Wall between their research and trading divisions.

2.84 In the absence of a Chinese Wall, their options (and the options of natural persons) are:

- to trade on the basis of the conclusions reached in their research, but not publish their report (that is, use it for internal trading purposes only), or
- to delay trading until the research report has become generally available.

In the latter circumstance, the publisher can be recompensed by selling its recommendations either generally or to its clients.

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

Transactions covered

Financial products covered by the prohibition

The issue

2.85 Should some of the financial products covered by the Financial Services Reform Bill be excluded from the insider trading provisions?

Australian law

2.86 Currently, the insider trading provisions only cover securities (including interests in managed investment schemes) and futures contracts. The insider trading provisions of the Financial Services Reform Bill cover these products as well as other derivatives, superannuation products, and any other financial products that can be traded on a financial market.¹⁸²

Advisory Committee view

Indices

2.87 The Advisory Committee Report *Regulation of On-exchange and OTC Derivatives Markets* (1997) considered whether the insider trading provisions should apply to options and warrants over equity indices. The Report noted the argument that there is little likelihood that insider trading in those derivatives could occur.¹⁸³ However, insider trading could take place through “mirror trades”, that is, where an insider buys a derivative on an aggregate share index and sells short the shares in individual companies covered by that index, other than the company about which the insider has inside information. This is equivalent to having directly bought shares in that company. For this reason, the insider trading prohibition should apply to index options and index warrants, as under the Financial Services Reform Bill, though mirror trades may be rare, given the transaction costs.

Derivatives over commodities

2.88 The 1997 Advisory Committee Derivatives Report noted that one argument for extending the insider trading provisions to exchange-traded derivatives over commodities is that permitting people to trade while in possession of inside information could distort the efficient price discovery mechanism of commodities markets and may generate uncertainty about whether parties are trading on the basis of confidential price-sensitive information.

2.89 However, some respondents to the Derivatives Review opposed extending the insider trading prohibition beyond derivatives over equities. They pointed out that the prohibition on insider trading of derivatives over equities supports the prohibition on the insider trading of the underlying equities themselves. However, to extend the insider trading provision to derivatives over commodities would prohibit a person from buying or selling derivatives over a commodity (when in possession of confidential price-sensitive information concerning that commodity), although that person could still lawfully buy or sell the physical commodity itself. In consequence, the insider trading prohibition would apply to the derivative, but not to its underlying asset.

2.90 A contrary argument is that undesirable insider trading is still possible in a commodity derivatives market. One example might be an executive of a large mining

¹⁸² Financial Services Reform Bill 2001 s 1042A definition of “financial products”. Derivatives are defined in s 761D of that Bill.

¹⁸³ HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.650].

company who takes a short position in gold futures contracts on the basis of confidential information about the discovery of a large gold deposit by that company, in the knowledge that the announcement of an increased supply of gold from this discovery is likely to cause the price of gold, and hence the price of gold futures contracts, to fall. Another example would be a person with confidential information concerning a very large transaction about to occur in a commodity that would affect the value of futures contracts over that commodity. Therefore, in principle, the insider trading provisions should apply to derivatives over commodities, albeit that it may be relatively rare for individuals to hold confidential price-sensitive information that would materially affect a particular commodities market.

2.91 Market practices and perceptions may also be relevant. It has been argued that commodity producers should at least be permitted to hedge (in the commodity derivatives market) any existing contractual delivery obligations before disclosing information (for instance, under listing obligations) that is also relevant to the price of commodity derivatives.

2.92 Similarly, assume that a commodity producer (CP) has confidential information that it will not be able to supply to the market as much of the commodity (for instance, energy) as it had to date. That information, once disclosed, will drive up the price of the commodity and the price of the commodity derivative. On one view, CP should be entitled to protect its own commercial interests by hedging any uncovered positions and protecting itself against any additional risks arising out of the news before it makes any disclosure of the reduction in supply. However, it is less clear whether it would be reasonable for CP to overhedge or otherwise profit at the expense of other users of the market prior to release of the information.

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

On-market and off-market application of insider trading prohibition

The issue

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

Australian law

2.94 The Australian legislation applies to the securities of all bodies corporate.¹⁸⁴ It is not confined to the securities of public companies or listed entities, except in one instance.¹⁸⁵

¹⁸⁴ s 1002(a).

¹⁸⁵ The prohibition on communication of inside information by an insider to a third party only applies to securities of listed public companies: s 1002G(3).

Overseas law

2.95 Most overseas jurisdictions confine the insider trading provisions to transactions in which there is a direct or indirect link between the securities, or the parties, involved and a public market. All jurisdictions cover transactions in securities that are traded on-market. In addition, various jurisdictions extend their insider trading laws to:

- transactions in securities that are capable of being traded, whether or not they are actually traded, on-market¹⁸⁶
- transactions in any securities that give an indirect interest in tradeable securities¹⁸⁷
- transactions where the person trading has relied on or acted through a professional intermediary, or was himself or herself acting as a professional intermediary,¹⁸⁸ or
- transactions in securities of public issuers or securities that are distributed to the public.¹⁸⁹

Advisory Committee view

2.96 The *market fairness* and *market efficiency* rationales for prohibiting insider trading are concerned with the impact on public markets. On one view, the legislation should be confined to on-market transactions and those off-market transactions that can affect public markets, for instance where the securities involved are publicly tradeable (even if traded off-market) or create an indirect interest in tradeable securities. Also, the insider trading provisions could cover any transactions involving professional intermediaries, as in some overseas law, given the linkage to, and possible impact on, public markets.

2.97 The further extension of the provisions to securities of unlisted or proprietary companies can create practical problems. For instance, shareholders in many proprietary companies may not be aware of the application of the insider trading provisions to them. Also, it is usually not possible to avoid a breach of the insider trading provisions with respect to these companies by making the information publicly available. However, this problem may not be significant. In some cases, the matter can be resolved by appropriate exchange of information between the contracting parties so that each is aware of any confidential price-sensitive information, thereby attracting the equal information defence.

2.98 An argument against exempting off-market transactions is the possibility of avoidance, if any exemption includes the securities of proprietary holding companies of public companies. A person with inside information might be able to trade in the proprietary holding company's securities, notwithstanding that he or she is prohibited

¹⁸⁶ Germany, South Africa.

¹⁸⁷ France.

¹⁸⁸ UK.

¹⁸⁹ Canadian provincial securities legislation, New Zealand.

from trading in the public company's securities. However, this would only affect shareholders of the proprietary holding company, who may have private contractual remedies. Persons transacting in shares of the public company would not be directly affected.

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

An entity issuing new securities

The issue

2.99 An entity may lawfully raise capital through new securities issues in the form of initial public offerings (IPOs) or rights issues. Should the insider trading provisions apply to new issues?

Australian law

2.100 In *Exicom Limited v Futuris Limited* (1995),¹⁹⁰ the Court ruled that the current insider trading provisions do not apply to new share issues.¹⁹¹ Therefore, a private initial placement by a company to a subscriber could not constitute insider trading (even if the company had confidential price-sensitive information not known to the subscriber). In so ruling, the Court relied on the Court of Appeal decision in *Hooker Investment Pty Ltd v Baring Brothers* (1986)¹⁹² that the insider trading provisions in the previous Companies Code should be restricted to previously issued shares.

2.101 The reasoning in the *Exicom* case is questionable, given that the *Hooker* decision was based on the language of the previous Code, which did not exempt underwriting agreements for new share issues. The Court in *Hooker* ruled that, unless new share issues were exempted, entry into an underwriting agreement for those shares would be very difficult. By contrast, the current legislation, which applied in the *Exicom* case, has a specific exemption for underwriting.¹⁹³

Overseas law

2.102 A New Zealand Discussion Paper raises the question whether a company's new share issues made pursuant to a prospectus should be specifically exempt from the insider trading prohibition.¹⁹⁴

2.103 SEC Rule 10b5-1 enables companies to make new securities issues, provided that directors reach the decision to issue securities before obtaining any inside information and they have no further discretion over the share issue scheme.

¹⁹⁰ (1995) 18 ACSR 404.

¹⁹¹ The Court ruled that s 1002G (the insider trading prohibition) was directed to market dealings in previously issued securities. Young J ruled that the word "subscribe" in s 1002G(2) does not include subscribing for new shares to be issued by the company, despite the very broad definition of "securities" in s 1002A(1).

¹⁹² (1986) 10 ACLR 462, 4 ACLC 243.

¹⁹³ s 1002J.

¹⁹⁴ New Zealand Ministry of Economic Development *Insider Trading Discussion Document* (September 2000) paras 3.27-3.28.

Advisory Committee view

2.104 New securities issues are an important means for companies to expand their financial base and ensure an appropriate equity/debt gearing ratio. The insider trading laws should not create inappropriate obstacles to this process. However, subscribers also need protection against the possibility of a company issuing new securities without disclosing negative inside information. Exempting new securities issues from the insider trading laws could deprive shareholders of this protection.

2.105 In many instances, a company would be required to disclose information either under continuous disclosure or in the prospectus accompanying the new issue.

2.106 The Committee acknowledges the practical problems faced by directors who are often likely to hold some confidential price-sensitive information. The principles in SEC Rule 10b5-1 may provide a suitable way of achieving a balance in some instances. Under those principles, a company could issue new securities, provided that the directors, at the time they resolved to make the securities issue offer, were not aware of any relevant confidential price-sensitive information (other than any information that would be disclosed before or pursuant to the issue offer), and had no subsequent discretion over the issue offer or its terms.

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

An entity buying back its issued securities

The issue

2.107 An entity may lawfully buy back its own securities. How should the insider trading provisions apply to this activity?

Australian law

2.108 A managed investment scheme may buy back members' interests without breaching 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.¹⁹⁵

2.109 In relation to companies, Young J in *Exicom Limited v Futuris Limited* (1995)¹⁹⁶ ruled that a company cannot be an insider in relation to its own shares, as:

¹⁹⁵ s 1002H. Securities, for the purpose of the insider trading provisions, include interests in managed investment schemes: s 1002A(1) definition of "securities". The buy-back is permitted because the buy-back price is determined by objective factors, as per the constitution of a managed investment scheme, not by any person in possession of inside information. The right of members to withdraw from a managed investment scheme is regulated under ss 601KA-601KE.

¹⁹⁶ (1995) 18 ACSR 404.

“the theory behind insider trading is breach of fiduciary duty ... and ... the whole genesis of this aspect of the law from the law of fiduciary obligation shows that one does not owe a fiduciary obligation to oneself.”¹⁹⁷

In consequence, a company could buy back its own shares without reference to the insider trading provisions.

2.110 The conclusion in *Exicom* is questionable. The Australian insider trading provisions are not confined to persons who have some fiduciary link with the company whose securities are traded, nor do they require that there be any breach of fiduciary duty for insider trading to take place.

Overseas law

New Zealand

2.111 A New Zealand Discussion Paper considers whether share buy-backs should be specifically exempt from the insider trading provisions. The Paper argues that:

“Without any exception in the statute it seems that a company may be liable as an insider where it purchases shares pursuant to a buy-back. The statutory procedure in the [New Zealand] Companies Act regulating buy-backs contains detailed restrictions on the extent to which the board can hold material price-sensitive information which is not disclosed to shareholders when making a buy-back offer. In these circumstances it has been suggested that buy-backs should be taken outside the ambit of the insider trading provisions.”¹⁹⁸

2.112 In some, but not all, instances, the Australian share buy-back provisions require companies to make full disclosure of all information relevant to their shareholders’ decision whether to approve the buy-back proposal¹⁹⁹ or accept the buy-back offer.²⁰⁰ No statutory disclosure obligation applies to on-market buy-backs that do not exceed more than 10% of a company’s capital in any 12 month period.²⁰¹ Some confidential price-sensitive information may also be exempt from disclosure under the continuous disclosure requirements.²⁰²

United States

2.113 US companies that engage in share buy-backs while in possession of inside information are potentially liable for insider trading under the fiduciary duty

¹⁹⁷ At 408-409.

¹⁹⁸ New Zealand Ministry of Economic Development *Insider Trading Discussion Document* (September 2000) para 3.26.

¹⁹⁹ ss 257C(2), 257D(2).

²⁰⁰ s 257G.

²⁰¹ s 257B(1).

²⁰² ASX Listing Rule 3.1.1 contains various exceptions to the continuous disclosure requirements, including where the information concerns an incomplete proposal or negotiation, comprises matters of supposition, is insufficiently definite to warrant disclosure, is generated for the internal management purposes of the entity or is a trade secret.

rationale.²⁰³ To make these buy-back powers more workable, SEC Rule 10b5-1 now permits companies to engage in buy-backs without running the risk of insider trading, provided that the directors make the buy-back decision before obtaining any inside information and they have no further discretion over the scheme.

Advisory Committee view

2.114 Buy-backs are a well-recognised method for companies to contract their equity base. The insider trading laws should not create inappropriate obstacles to this process. However, shareholders also need protection against a company taking advantage of inside information to buy back its shares for less than what the company would have to pay if the information was disclosed, thereby advantaging remaining shareholders over selling shareholders. This favouring of one class of shareholders over another class is inconsistent with the basic principle of corporate governance to treat all shareholders equally.

2.115 To apply the insider trading rules to buy-backs is consistent with a recommendation in a previous Insider Trading Report, and comments by other commentators, that a company should be an insider in relation to its own securities.²⁰⁴

2.116 The principles in SEC Rule 10b5-1 would provide a suitable way of permitting buy-backs in some circumstances. Under those principles, a company could buy back its shares, provided that the directors, at the time they resolved to make the buy-back offer, were not aware of any relevant confidential price-sensitive information (other than any information that would be disclosed before or pursuant to the buy-back offer) and had no subsequent discretion over the buy-back offer or its terms.

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

Exercise of physical delivery option rights by informed persons

The issue

2.117 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

²⁰³ Under US corporate law, companies that engage in share buy-backs owe a fiduciary duty to shareholders who sell their shares to the company under that scheme: *Shaw v Digital Equipment Corp* 82 F.3d 1194 (1996).

²⁰⁴ P Anisman, *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* (NCSC, 1986) at 22-23. HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.650] argues that:

“There may be policy reasons why the company should be considered an insider [in relation to its own securities]. For example, it is possible for a company to engage in insider trading when it buys back its own shares. In this case, the gains which accrue where a company buys back its shares at a price which is lower than their value would be if the inside information was publicly available, benefit the shareholders who do not have their shares bought back.”

counterparty or the clearing house) if in the meantime they become aware of relevant inside information, thereby becoming informed persons?

Australian law

2.118 Entry into option contracts to buy or sell securities is subject to the insider trading provisions.²⁰⁵ Likewise, exercise of a physical delivery right under an option contract would constitute a purchase²⁰⁶ or sale²⁰⁷ of the affected securities, also within the insider trading provisions. In consequence, any party to a physical delivery option contract who becomes aware of inside information in the period between entry into and exercise of that option contract (an informed person) cannot lawfully exercise a physical delivery option right. Mere disclosure of the information to the counterparty, even if possible, may not suffice to permit the informed person to exercise the option.²⁰⁸ Also, the informed person would not have the defence of acting pursuant to a legal obligation.²⁰⁹

2.119 By contrast, an informed person who obtains negative inside information in the interim period may lawfully decide not to exercise a physical delivery option, given that the Australian legislation does not apply to non-trading.

Overseas law

2.120 Put and call options are subject to the insider trading provisions of overseas jurisdictions.

2.121 In some instances, an informed person who holds a put or call option could seek to rely on a statutory use requirement, or a “non-use” defence, in exercising the physical delivery rights, that is, the insider did not use the inside information in deciding to exercise those rights (see paras 2.144-2.147).

²⁰⁵ s 1002G(2), (3) prohibit an insider from entering into an agreement to purchase or sell securities. Paragraph (e) of the definition of “securities” in s 1002A(1) refers to “an option contract under which a party acquires from another party an option or right, exercisable at or before a specified time, to buy from, or sell to, that other party a number of securities ... at a price specified in, or to be determined in accordance with, the contract”.

²⁰⁶ For instance, A and B enter into a physical delivery put option (the first transaction), whereby A can require B to buy specified securities from A. If A exercises that physical delivery right, B must purchase the specified securities from A (the second transaction). The second transaction would constitute a purchase for the purpose of the prohibitions in s 1002G(2), (3).

²⁰⁷ For instance, A and B enter into a physical delivery call option (the first transaction), whereby A can require B to sell specified securities to A. If A exercises that physical delivery right, B must sell the specified securities to A (the second transaction). The second transaction would constitute a sale for the purpose of the prohibitions in s 1002G(2), (3).

²⁰⁸ Under s 1002T(2)(b), it is a defence “if the Court is satisfied that the other party to the transaction or agreement knew, or ought reasonably to have known, of the information before entering into the transaction or agreement”. Presumably, this refers only to entry into an option contract, not its exercise, given that its intended purpose is to exempt transactions where both parties, each with inside information, have freely entered into the agreement. Arguably, it could not apply at the time of exercise of the option, as only one party has any discretion at that time.

²⁰⁹ Section 1002K provides that the insider trading prohibition does not apply in respect of the purchase of securities pursuant to a requirement imposed by the Corporations Law. Exercise of an option is pursuant to a private contract, not the Corporations Law. Also, the exercise could not be said to be pursuant to a “requirement”: the insider could simply allow the option to lapse unexercised.

2.122 The UK and South African provisions also have a defence for an insider who shows that “he would have done what he did even if he had not had the information”.²¹⁰ The informed person could provide evidence that he or she would have exercised the physical delivery right even in the absence of the inside information.

Advisory Committee view

2.123 It appears anomalous that a person who bona fide enters into a physical delivery option contract, and subsequently becomes an informed person, can settle that contract in cash,²¹¹ but cannot exercise the alternative physical delivery rights unless the later-acquired inside information has become generally available before the exercise period expires.

2.124 An informed person should be permitted to exercise physical delivery rights (and thereby receive the securities from the counterparty under a call option or require the counterparty to take delivery of the securities under a put option), provided that this person did not have inside information at the time of entry into the option contract and the exercise price was fixed at that time. Persons should be entitled to the benefit of rights for which they contracted in good faith.

2.125 An informed person in these circumstances may sometimes have an advantage over other option holders, for instance, exercising a physical delivery call option (when in possession of later-acquired positive inside information) where other, uninformed, call option holders let their options lapse (given that they appear to be out-of-the-money). 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.

2.126 An exemption for exercise of physical delivery rights by informed persons could, however, be abused if the exercise price could be determined by events after entry into those contracts. An example might be a call option between a company and its directors whereby the directors may subscribe for their company’s shares, at any time before expiry of the option, for the market price (or some discount on that price) at the time of exercise. The directors could take advantage of any price-positive inside information by exercising their options to subscribe for the shares before releasing that information. By contrast, outright on-market share acquisitions by these directors in these circumstances would continue to constitute insider trading. For these reasons, the Advisory Committee supports an exemption only where the exercise price is fixed on entry into the original option contract.

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

²¹⁰ UK Criminal Justice Act s 53(1)(c), South African Insider Trading Act 1998 s 4(1)(b).

²¹¹ Cash-settled option contracts do not involve any purchase or sale of securities, and therefore fall outside the insider trading prohibitions in s 1002G(2), (3).

Exercise of physical delivery option rights by uninformed counterparties

The issue

2.127 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)?²¹² In practice, this issue would only be of concern in face-to-face off-market transactions, given the clearing house novation arrangements for on-exchange transactions.

Australian law

2.128 As previously indicated (para 2.118), the Australian insider trading provisions apply both at the time of entry into option contracts and at the time of their exercise. Persons who become aware of inside information in the interim period (informed persons) would be caught by these provisions if, at the direction of the uninformed counterparty, they either purchased securities from the counterparty (to honour the exercise of a physical delivery put option by the counterparty) or purchased securities from a third party (to honour the exercise of a physical delivery call option by the counterparty). In consequence, informed persons may be unable to honour their physical delivery obligations.²¹³

Overseas law

2.129 Under the UK and South African law, an informed person could argue that he or she was obliged to transact in the affected securities in order to honour the physical delivery option contract with the counterparty and therefore “he would have done what he did even if he had not had the information”.²¹⁴

2.130 It has been recommended that the Canadian federal legislation be amended to specifically exempt informed persons transacting in securities under option contracts exercised by uninformed counterparties.²¹⁵

²¹² This Paper does not review the case where a person at the time of entry into an option contract with an uninformed counterparty possessed relevant inside information, thereby breaching the insider trading provisions. In this case, the uninformed counterparty has common law remedies for illegality of contract.

²¹³ The option contract may provide for alternative remedies, for instance, that the counterparty purchases the shares and claims any costs additional to the option price from the defaulting party.

²¹⁴ UK Criminal Justice Act s 53(1)(c); cf South African Insider Trading Act 1998 s 4(1)(b).

²¹⁵ Industry Canada: Insider Trading Discussion Paper February 1996 para [148].

Advisory Committee view

2.131 It is anomalous that an uninformed counterparty can require settlement of a put or call option contract in cash, but may be unable to enforce physical delivery rights if the other party has become an informed person. This anomaly could be avoided by applying the insider trading provisions, in this context, only at the time of entry into the option contract. In consequence, an informed person could lawfully transact in affected securities if so required by the uninformed counterparty.

2.132 It is not necessary to limit this exception to option contracts that fix the exercise price, given that the physical delivery discretion in this case lies with the uninformed counterparty, not the informed person.

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

Subjective elements

Awareness and knowledge of inside information

The issue

2.133 Should a person's liability for breaching the insider trading provisions require that the person both be aware of the relevant information and know that it is inside information?

Australian law

2.134 Under the Australian legislation, the prosecution must prove:

- *awareness of the information*, that is, the defendant was aware of (possessed) the relevant information at the time of trading or procuring (*subjective awareness test*),²¹⁶ and
- *knowledge that the information is inside information*, that is the defendant knew (*subjective knowledge test*) or ought reasonably to have known (*objective knowledge test*) that this information was not generally available and was materially price-sensitive.²¹⁷

²¹⁶ This matter is not totally beyond doubt. The insider trading prohibition in s 1002G(1) applies to a person who "possesses" information. Section 86 states that "a thing that is in a person's custody or under a person's control is in the person's possession". However, it seems unrealistic to apply this provision to insider trading, as this could extend these provisions to situations where persons had physical custody, say, of documents containing confidential price-sensitive information, but without being aware of the nature, content or price significance of those documents.

²¹⁷ s 1002G(1)(b), (2).

These awareness and knowledge tests are consistent with the recommendations in the Griffiths Report.²¹⁸

Overseas law

Awareness of the information

2.135 Most overseas jurisdictions require proof that the person was subjectively aware of particular information.

2.136 However, French courts have implied into the French criminal insider trading law a presumption of awareness of particular information in limited circumstances. Thus, any persons who were the directors of, or were otherwise involved in, the management of a company and who traded in the securities of that company are deemed to be aware of any inside information that derived from within that company when they conducted the transactions. The defence has the onus of rebutting that presumption of awareness.²¹⁹

Knowledge that the information is inside information

2.137 The UK and South African provisions apply only the subjective knowledge test, that is, the defendant must “know” that the information is inside information.²²⁰ There is no equivalent of the alternative objective knowledge test. Various commentators have referred to the difficulties in proving subjective knowledge:

“It is clear that [under the South African and UK provisions] only subjective appreciation of these facts will do. Thus, for example, if the accused thinks (no matter how unreasonably) that the information is public, then he does not commit the offence. The prosecution will have to prove that this subjective requirement has been met and it is of concern that perpetrators may be able, too readily, to avoid prosecution on the basis of ‘lack of knowledge’”.²²¹

2.138 By contrast, the Monetary Authority of Singapore (MAS) proposes that the Australian subjective/objective knowledge tests, modified by a presumption of knowledge, apply to “connected persons”, but that only the subjective knowledge test, with no presumption, apply to non-connected persons. Under these proposals:

²¹⁸ *Fair Shares for All*, paras 4.10 - 4.10.9 and Recommendation 10.

²¹⁹ *Tribunal de Grande Instance de Paris*, 3 December 1993, *Gazette du Palais*, 27-28 May 1994, pp 28 ff. M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 166.

²²⁰ UK Criminal Justice Act 1993 s 57(1) provides that “a person has information as an insider if and only if ... it is, and he knows that it is, inside information ...”. Cf the South African Insider Trading Act 1998 s 2(1), which refers to “any individual who knows that he or she has inside information”.

²²¹ R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 294. Also, M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 101 note that the difficulties in proving subjective knowledge under UK law have resulted in the collapse of a number of insider trading prosecutions.

- liability of directors, other officers and other connected persons²²² for breach of the insider trading provisions would depend on showing that they knew (subjective knowledge test) or ought reasonably to have known (objective knowledge test) that any information concerning their corporation was not generally available and was materially price-sensitive.²²³ Connected persons would be presumed to have satisfied these knowledge tests, unless they can prove otherwise on a balance of probabilities.²²⁴ The MAS considers that this approach will introduce greater discipline for those in fiduciary positions²²⁵
- by contrast, liability of non-connected persons would depend on proof of the subjective knowledge test, that is, that they knew that the information in their possession was not generally available and was price-sensitive.²²⁶

Advisory Committee view

Awareness

2.139 Obtaining corroborative evidence that a person was subjectively aware of inside information can be one of the most difficult aspects of insider trading investigations.

2.140 The French rebuttable presumption of awareness may assist in insider trading prosecutions against directors and managers of a company, who may be the persons most likely to be aware of inside information. However, it would not overcome the evidential difficulties in proving awareness in any prosecutions against third persons who may have received inside information from directors or managers. The mere existence of a relationship between a director or manager and a third person would not usually be sufficient to prove that the inside information had been passed on to the third party.

²²² The draft Securities and Futures Act 2001 s 208(5) defines persons who are connected to a corporation to include:

- any director or other officer (as defined in s 208(6))
- any substantial shareholder of that corporation or of a related corporation
- any person who occupies a position that may reasonably be expected to provide access to inside information by virtue of any professional or business relationship between the person (or the person's employer) and that corporation or a related corporation, or through being an officer of a substantial shareholder of that corporation or a related corporation.

²²³ Draft Securities and Futures Act 2001 s 208(1)(b).

²²⁴ This is the apparent intention of the draft Securities and Futures Act 2001 s 208(4), which provides that:

“In a prosecution of a person for a contravention of [the trading, procuring or disclosing offences], where the prosecution proves that the insider who is connected to a corporation knows or ought reasonably to know that he possesses information concerning that corporation 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 securities of that corporation, it shall be presumed that such a connected person knows, or ought reasonably to know, that the information is not generally available and if it were generally available, it would have a material effect on the price or value of those securities, unless he can prove otherwise, on a balance of probabilities.”

²²⁵ MAS, *The Securities and Futures Act 2001 Consultation Document* (March 2001) at 27.

²²⁶ Draft Securities and Futures Act 2001 s 207(1)(b).

Knowledge

2.141 A rebuttable presumption that directors and other connected persons are aware that information they hold is inside information could also assist in insider trading prosecutions. The contrary argument is that it is not generally appropriate to have presumptions of this nature in criminal proceedings, even against persons closely connected with the source of the inside information.

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

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

Use of inside information

The issue

2.142 Should criminal liability for insider trading require that a person holding inside information has used (relied on) that information in trading?

Australian law

2.143 The Corporations Law does not require the prosecution to show that a person holding inside information used that information when trading in affected securities. The Griffiths Report recommended that the legislation provide that a person shall not use confidential price-sensitive information to trade in securities.²²⁷ However, the Government at the time of introducing the 1991 amendments to the insider trading law took the view that, once the prosecution has proved that the person was in possession of the inside information and traded in the relevant securities, it was reasonable to assume that the person was motivated to trade by possession of that information.²²⁸ However, there is no case law that deals with this matter.

Overseas law

Use requirement

2.144 Some jurisdictions require the prosecution to prove that the defendant used or took advantage of the inside information.²²⁹

Defence of non-use

2.145 Some other jurisdictions provide a defence of non-use, namely, that the insider can show that he or she would have acted in the same manner even without the inside information.²³⁰ This defence may be available to an insider who transacted in order to

²²⁷ *Fair Shares for All* Recommendation 2.

²²⁸ Government Response to *Fair Shares for All*, para 29.

²²⁹ Germany, Canadian federal legislation, Singapore (though the draft Singapore Securities and Futures Act 2001 abolishes the use requirement).

²³⁰ UK, South Africa.

meet a pressing financial need or contractual obligation²³¹ or who simply followed independent professional advice²³² or a general trading strategy.²³³

2.146 One commentator has pointed to other ways in which the non-use defence might operate:

“This effectively allows certain individuals to avoid a conflict of interest between their contractual or fiduciary obligations and the fact that they have personal knowledge of inside information at the time. For example, the insolvency practitioner who has to liquidate all the assets of an insolvent company can safely deal if he has also price-sensitive information about the securities he is about to sell.”²³⁴

2.147 By contrast, there has been some criticism of this non-use defence, at least as it applies to forced sales:

“Although these defences are designed to exonerate forced sales, eg to pay back tax or satisfy pressing trade creditors, in one sense there is no legitimate reason why they should be allowed, since imprudence in handling one’s business affairs such as to require panic realisation of assets is hardly a justification for acting on inside information.”²³⁵

Specific defences

2.148 The United States and the Canadian provinces have taken a different approach by having various specific defences instead of a use requirement.

2.149 SEC Rule 10b5-1 was introduced in 2000 to override previous court decisions that applied a use requirement in the US insider trading laws. The SEC Rule abolishes the use requirement, but permits persons to structure securities trading plans and strategies, including selective buy-backs, employee share plans or dividend re-investment plans, which may be implemented at any future time, provided that those persons are not aware of material nonpublic information at the time of devising the plan, entering into a binding contract to purchase or sell securities or instructing

²³¹ *Gower’s Principles of Modern Company Law* (Sweet & Maxwell) 6 Edition, 1997 at 470, R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 296.

²³² Rider, Abrams, Ashe, *Guide to Financial Services Regulation* (CCH) 3rd Edition 1997 at 234-5.

²³³ P Mitchell, *Insider Dealing* in UK Butterworths Corporate Law Service: Corporate Transactions, Chapter 8, para [8.141] gives the following examples:

“X decides on strategic investment grounds to increase his portfolio exposure in European recovery stocks and selects shares in Y GmbH which are rising in value. X also has price-sensitive information about Y GmbH but does not buy the shares for that reason. The ‘lack of intention’ defence should apply.

X decides that his property securities holdings are declining in value and that he must liquidate the entire portfolio. He has information about Z plc, which will cause its shares to fall even faster than the remainder of the market sector. The ‘inevitable transaction’ defence ought to apply here.”

²³⁴ R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 296.

²³⁵ P Mitchell, *Insider Dealing* in UK Butterworths Corporate Law Service: Corporate Transactions, Chapter 8, para [8.142].

an agent to do so and have no discretion over the previously determined trading plan if they later become aware of any inside information.

Advisory Committee view

2.150 There should be no requirement that the prosecution prove that the defendant used the inside information. 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.

2.151 A defence of non-use would assist defendants who can establish that their trading is totally unrelated to their possession of inside information. However, it 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.

2.152 By contrast, specific defences similar to SEC Rule 10b5-1 may provide companies and individuals with the flexibility to plan their securities trading at a time when they have no inside information advantage over other market participants. Without some exemption, bona fide market participants may be unable to trade because of information that comes to their attention after they have reached their trading decisions. The evidential onus should rest on persons relying on the Rule to establish that they acted before becoming aware of the inside information.

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

Trading contrary to inside information

The issue

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

Australian law

2.154 The statutory prohibition on trading²³⁶ applies, regardless of whether that trading is consistent with the likely price impact of the inside information.

Overseas law

2.155 The UK legislation provides a defence if the defendant can show:

“that he did not at the time expect the dealing to result in a profit [or avoidance of a loss] attributable to the fact that the information in question was price-sensitive information in relation to the securities”.²³⁷

²³⁶ s 1002G.

²³⁷ Criminal Justice Act 1993 s 53(1)(a), (6).

2.156 By contrast, the South African legislation, which is largely modelled on the UK provisions, has not included this defence.

Advisory Committee view

2.157 There may be an assumption in the commercial community that any trading contrary to inside information is permitted, or is at least less reprehensible, as the insider has not benefited from the transaction. Also, a regulator may be less likely to take action against a person who clearly traded contrary to inside information.

2.158 The Advisory Committee, however, does not support the UK defence. The risk remains of its 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 whether it will increase or decrease the price of the securities (for instance, the pending resignation of a senior executive or a planned merger). A UK-type provision may provide a fortuitous defence to 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.

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

Exemptions

Underwriting

The issue

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

2.160 Should an underwriter be permitted to on-sell securities taken up under an underwriting agreement before inside information given to the underwriter becomes generally available?

Australian law

2.161 The insider trading provisions do not apply to:

- the communication of inside information solely for the purpose of procuring a person to enter into an underwriting or sub-underwriting agreement (*communication exemption*)²³⁸
- an underwriter or sub-underwriter who has that inside information subscribing for securities under that agreement (*subscription exemption*)²³⁹

²³⁸ s 1002J(2).

²³⁹ s 1002J(1)(a), (b).

- an underwriter or sub-underwriter who has that inside information on-selling securities acquired under an underwriting agreement (*on-selling exemption*).²⁴⁰

2.162 The 1989 Griffiths Report referred to submissions arguing for the subscription and on-selling exemptions.²⁴¹ The Report supported these two exemptions, without any discussion of their merits.²⁴² The Explanatory Memorandum to the 1991 insider trading amendments adopted the Report's recommendation, without any comment.²⁴³

Advisory Committee view

Communication exemption

2.163 It is essential to retain the communication exemption. Underwriters and sub-underwriters quite reasonably require full disclosure of all relevant information in deciding whether to underwrite a proposed issue. Without these disclosures, underwriters (and sub-underwriters) would not be prepared to provide this essential service. Likewise, intending issuers need to have the freedom to disclose confidential price-sensitive information to potential underwriters during negotiations to select the underwriter and agree on the terms of the underwriting.

Subscription exemption

2.164 The subscription exemption is justifiable in principle, though it may not be strictly necessary, given that the equal information defence would apply to transactions between the company and the underwriter (or sub-underwriter) where all relevant information has been disclosed.

On-selling exemption

2.165 On one view, the on-selling exemption may assist companies to raise capital. Companies may find it more difficult to obtain an underwriter at a reasonable cost unless the underwriter has the discretion to on-sell the securities that may have to be taken up under an underwriting agreement, even where inside information known to the underwriter is not yet generally available.

2.166 From another perspective, there is no clear justification for any on-selling exemption in the pre-public disclosure period. Arguably, the right of underwriters to on-sell securities in this period should be limited to sales to sub-underwriters. In this case, the existing equal information defence would apply, given the commercial practice of all material information being disclosed to underwriters and sub-underwriters. Permitting on-selling to uninformed counterparties may be contrary to the market fairness and market efficiency rationales behind the insider trading prohibition.

²⁴⁰ s 1002J(1)(c).

²⁴¹ *Fair Shares for All*, para 4.3.4.

²⁴² Recommendation 2.

²⁴³ para 349.

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

Transactions by external administrators

The issue

2.167 Should external administrators of companies and the equivalent representatives of personal estates be exempt from the insider trading provisions in the exercise of their official powers?

Australian law

2.168 Liquidators, personal representatives of deceased persons and trustees in bankruptcy may lawfully transact in securities, notwithstanding that they hold inside information about those securities, provided they act in good faith and in the performance of the functions of their office.²⁴⁴

2.169 There is no equivalent statutory protection for administrators, scheme managers, receivers, and receivers and managers. These persons are only protected for any transaction that is entered into pursuant to a *requirement* (as opposed to in the mere exercise of a power) imposed by the Corporations Law,²⁴⁵ or for communicating any inside information pursuant to any requirement imposed by a government or regulatory authority.²⁴⁶

Advisory Committee view

2.170 The rationale of the current exemption for liquidators, personal representatives of deceased persons and trustees in bankruptcy is not readily apparent. On the one hand, these office holders would not gain personally from securities trading, which could also assist in the effective and expeditious fulfilment of their functions. However, such trading could be seen as being contrary to the principles of market fairness and market efficiency. Given this, it is also questionable whether administrators, scheme managers, receivers, and receivers and managers should have any exemption.

2.171 On one view, any exemption should be limited to inside information that external administrators have obtained before their appointment. Without that exemption, some companies could be prejudiced simply by the pre-existing state of knowledge of the particular appointee.

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

²⁴⁴ Corporations Regulations reg 7.11.01(1)(d).

²⁴⁵ s 1002K.

²⁴⁶ s 1002L.

Intermediaries

Liability of an insider when trading through an intermediary

The issue

2.172 Persons with inside information may attempt to trade through intermediaries. Should they be liable when they instruct a broker to trade, when that broker places their offer on the market, when that offer is accepted by a counterparty broker or at some other time?

Australian law

2.173 The Corporations Law, prior to 1991, provided that an insider “shall not deal” in relevant securities.²⁴⁷ “Deal” includes making an offer.²⁴⁸ Thus, for instance, if the pre-1991 insider trading provision still applied, a person could breach the legislation when his or her broker enters an offer on a SEATS terminal, whether or not the offer is accepted.

2.174 However, the 1991 amendments adopted different language. An insider must not “subscribe for, purchase or sell, or enter into an agreement to subscribe for, purchase or sell, any such securities”.²⁴⁹ A comparable prohibition applies to procuring a trade by another person or communicating inside information to another person who would be likely to trade.²⁵⁰

2.175 In *R v Evans and Doyle* (1999)²⁵¹ (the *Mt Kersey* case), the Court held that the relevant “agreement” referred to in the statutory prohibition was the on-market broker-to-broker agreement, not the earlier client-broker agreement to trade.²⁵²

²⁴⁷ s 1002(1), prior to its repeal in 1991.

²⁴⁸ s 9 definition of “deal”.

²⁴⁹ s 1002G(2)(a).

²⁵⁰ s 1002G(2)(b), (3).

²⁵¹ Supreme Court of Victoria, 15 November 1999.

²⁵² The Court identified four agreements in a traditional on-market purchase, namely, the two initial agency agreements between the future contracting parties and their brokers, the later on-exchange contract between the brokers, and the deemed simultaneous consequential contract between the contracting parties. The Court held that the reference to “enters into an agreement” to purchase or sell securities in s 1002G(2)(a) refers in the context of market trading not to the initial agency contract but to the later contract entered into by the buying and selling brokers on behalf of their clients:

“the agreement to purchase the securities is entered into by the buying broker on behalf of his client when such agreement is concluded with the selling broker, thereby causing the buying broker’s client to enter in an agreement with the seller to purchase the securities”.

By contrast:

“a person instructing a broker to purchase shares on the exchange market on his or her behalf ... does not enter into an agreement to purchase securities within the provisions of s 1002G(2)(a). In such circumstances, the client is entering into an agency contract or agreement. It is only if and when a trade or agreement to purchase the securities has been achieved by the broker that, as an agent, the broker enters into an agreement to purchase securities causing the principal also to enter an agreement to purchase securities”.

In excluding the earlier agency agreement, the Court referred to the possibility of events intervening following a client instructing the broker to acquire or sell shares:

2.176 One consequence of the *Mt Kersey* case is that the insider trading provisions apply to any person who receives inside information about particular securities in the period between giving instructions to the broker to transact in those securities and the counterparty's broker accepting the offer. In consequence, that person may need to take all reasonable steps to cancel an order prior to its acceptance.

Overseas law

2.177 Under the UK and South African provisions, an insider is not guilty of insider dealing by virtue of dealing in securities if the insider shows that he or she would have acted in the same manner even without the inside information.²⁵³ This defence could be raised by persons who became insiders only after giving instructions to their brokers and thereafter did not alter those instructions.

2.178 One US commentator argued that persons in these circumstances should be required to cancel the trade, unless this involves a penalty:

*“So long as the ability to cancel without liability is present, a decision not to cancel is, in effect, an investment decision.”*²⁵⁴

2.179 Subsequently, however, SEC Rule 10b5-1 introduced a specific affirmative defence to a breach of the insider trading provisions that, “before becoming aware of the information, the person had instructed another person to purchase or sell the security for the instructing person's account”. That exclusion only applies to instructions given in good faith and not as part of a plan or scheme to evade the insider trading prohibition.

Advisory Committee view

2.180 There are at least three options for determining the time when insiders who act through a broker or other market intermediary incur liability:

- *when the client gives instructions to a broker.* 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. In this respect, this result would reflect the approach in SEC Rule 10b5-1
- *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

“for example, there may be no shares at the authorised price being offered for sale. Again, before the broker enters into the transaction, the broker's authority may be withdrawn”.

²⁵³ Criminal Justice Act 1993 s 53(1)(c), South African Insider Trading Act 1998 s 4(1)(b).

²⁵⁴ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §3.04 at 3-28.

- *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.

2.181 The first or second policy option could have anomalous results. A person could be liable for insider trading, even where no trading took place (for instance where the instructions were not carried out or were withdrawn, or an offer placed on the trading system was subsequently withdrawn or not matched).

2.182 The third policy option would avoid this problem and apply the insider trading provisions when on-market contracts are made. However, as noted above, this policy option 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.

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

Intermediary acting on clients' instructions

The issue

2.183 Can an intermediary carry out a client's instructions to trade in particular securities if that client has revealed to the intermediary inside information concerning those securities, or that the client holds inside information, without revealing the actual information?

Australian law

2.184 A person working within the office of a broker or other intermediary may lawfully carry out the instructions of a client, even where the office holds relevant inside information, provided that the person acts under specific instructions from the client and the person was not aware, and there were arrangements to ensure that he or she could not be aware, of the inside information.²⁵⁵ However, this Chinese Walls provision is not designed to deal with the situation where the inside information comes from the client.

2.185 On one view, an intermediary who acts for a client when aware that the client has confidential price-sensitive information would be liable for aiding and abetting any breach of the insider trading provisions by that client. This matter was raised, but not decided, in the *Mt Kersey* case.²⁵⁶

²⁵⁵ s 1002S. In addition, ASX Business Rule 3.5 deals with Chinese Walls for brokers.

²⁵⁶ *R v Evans and Doyle* Supreme Court of Victoria, 15 November 1999.

Overseas law

Revealing the inside information

2.186 The South African legislation deals directly with this matter. It provides that an intermediary trading for a client is not guilty of an offence if the intermediary proves on a balance of probabilities that he or she:

“was acting on specific instructions from a client, *save where the inside information was disclosed to him or her by that client*”.²⁵⁷ [emphasis added]

This makes it clear that an intermediary cannot lawfully transact in particular securities on the instructions of a client who has given the intermediary inside information regarding those securities.

Revealing that the client has inside information

2.187 The UK Financial Services Authority Code of Market Conduct provides that intermediaries will be civilly liable for market abuse (including insider trading) in executing the instructions of their clients only if they knew or ought to have known that their clients were themselves engaging in market abuse when the intermediaries executed the clients' transactions.²⁵⁸ Where these elements are satisfied, there is no requirement that the inside information be disclosed to the intermediary.

Advisory Committee view

2.188 The Advisory Committee supports the South African and UK principles, which seek to provide clear guidance to practitioners. An intermediary who has knowingly received inside information from a client, or has merely been informed by the client that the client holds inside information, should be prohibited from transacting in affected securities for that client. The Advisory Committee has not reached a view on whether this prohibition should apply where the intermediary should have been aware that the client held inside information.

2.189 An intermediary who has been informed by a client of inside information, or that the client has inside information, should be entitled to transact for other, uninformed, clients in affected securities only on an “execution-only” basis.

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

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

²⁵⁷ South African Insider Trading Act 1998 s 4(1)(a).

²⁵⁸ FSA Code of Market Conduct April 2001, para 10.3.

Internal controls over insiders

Persons trading on behalf of an entity: the Chinese Walls defence

The issue

2.190 The Australian legislation seeks to permit organizations to both research and trade, while protecting themselves from the insider trading provisions for any dealing done on their behalf, through the use of Chinese Walls between their research and trading divisions. However, is the concept of Chinese Walls outdated? Alternatively, are the current Australian Chinese Wall provisions too limited?

Australian law

2.191 The insider trading provisions apply to any person who “possesses” confidential price-sensitive information. A body corporate is taken to possess any information held by any of its officers in the course of their duties.²⁵⁹ A comparable provision applies to partnerships.²⁶⁰ However, these entities can avoid possible contravention of the insider trading provisions through internal arrangements to ensure that no inside information or related advice is communicated within the organization to persons who are transacting on behalf of the organization.²⁶¹ A similar defence applies to licensees or their representatives in carrying out instructions of their clients.²⁶²

2.192 It is arguable that, as drafted, these Chinese Wall defences do not apply to the prohibited conduct of procuring another person to enter into securities transactions.²⁶³ Procuring in this context can include merely encouraging an act or omission by another person.²⁶⁴ This can result in the insider trading provisions being unduly wide.²⁶⁵

²⁵⁹ s 1002E. An officer is defined in s 9.

²⁶⁰ s 1002F.

²⁶¹ ss 1002M, 1002N.

²⁶² See paras 2.183-2.189.

²⁶³ s 1002G(2)(b). HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.660], [9.670] argues that the language of ss 1002M and 1002N, in effect, only covers the offence under s 1002G(2)(a), and does not cover the procuring offence under s 1002G(2)(b).

²⁶⁴ s 1002D(2).

²⁶⁵ HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.660] gives the following example:

“Suppose that a branch manager of a bank acquires inside information about a corporate customer of the bank. The bank itself is deemed by s 1002E(a) to possess that information, even if the branch manager has passed it on to no-one else within the bank. The bank manager knows that the information is not generally available, and would have a material effect on the price of the corporate customer's securities, and therefore the bank is presumed to know these things: s 1002E(b). Now suppose that an employee of the financial services division of the bank advises a client to buy or sell securities of the branch manager's customer, being unaware of the information, which the bank manager possesses. The advice encourages the client to trade and therefore procures the client to trade. Since the advice was given in the course of employment, it would appear that the procuring is attributable to the bank as principal, and the bank has therefore contravened s 1002G(2). However good the bank's Chinese walls may be, s 1002M is of no

Advisory Committee view

2.193 The first question is whether the principles that underlie the Chinese Wall defence continue to be relevant in financial intermediary organizations. On one view, the distinction between research and trading is becoming increasingly blurred, given modern information transfer technology and the involvement of personnel with specialist knowledge of particular financial instruments in both research and trading. It may be increasingly difficult to erect, or maintain, effective communication or knowledge barriers within an organization. This might suggest that consideration should be given to removing the Chinese Walls defence from the insider trading provisions.

2.194 The alternative view is that the Chinese Walls defence should remain available to those organizations that can effectively quarantine any inside information. Also, removal of the defence may simply lead to organizations setting up separate research and trading entities to overcome the effect of the provisions that attribute the knowledge of officers or partners to the entire entity.

2.195 If the Chinese Walls defence remains, entities with effective Chinese Walls should be protected from both the trading offence and the procuring offence. Extending the exemption to procuring would not breach the *market fairness* and *market efficiency* rationales of the insider trading provisions. There would be no unfairness or unjust enrichment when an organization's trading or procuring is done by a person who is unaware of any inside information held by that organization, given its Chinese Wall. The current limitation appears to reflect a legislative oversight, rather than any good policy reason for distinguishing between trading and procuring.

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

Persons trading on their own behalf: derivative civil liability

The issue

2.196 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?

Australian law

2.197 Bodies corporate and partnerships holding inside information are liable for any trading done *on their own behalf* where any inside information is held within the entity, unless they have effective Chinese Walls to quarantine the inside information from the person who trades. However, they are not liable where any informed person within the entity trades on his or her own behalf, not on behalf of the entity.

assistance because it protects the body corporate only in respect of the trading offence, not the procuring offence.”

Overseas law

2.198 United States legislation imposes derivative civil liability in some circumstances.

2.199 Any person who is in a position to control another person may be subject to derivative civil liability for any impermissible trading or tipping by that other person. That liability may be up to three times the profit gained or loss avoided by the insider or the insider's direct tippee.²⁶⁶ A "controlling person" is defined as "any person with power to influence or control the direction or the management, policies, or activities of another person". Control is inferred from possession of such power, whether or not it is exercised.²⁶⁷

2.200 A controlling person has derivative civil liability for any insider trading or tipping breach by a controlled person where it is established that:

"the controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred".²⁶⁸

In consequence, a controlling person may not deliberately disregard circumstances suggesting that a controlled person is breaching the insider trading provisions. The clearest example of reckless disregard would be where a controlling person has no, or an apparently inadequate, internal system to control access to, or dissemination of, confidential price-sensitive information, where such information exists or is likely to exist.

2.201 The express rationale for imposing derivative liability is that insider trading may be an institutional, as well as an individual, problem:

"Firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility."²⁶⁹

2.202 Controlling persons who are securities issuers may take various preventative steps to avoid derivative liability, including education of employees, controls over the internal dissemination of confidential price-sensitive information and reporting and other internal controls over trading in their own securities, particularly short selling or options trading in those securities. These precautions may help to rebut any claim that

²⁶⁶ Insider Trading and Securities Fraud Enforcement Act s 21A(a)(3).

²⁶⁷ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §8.02[2][b] at 8-16.

²⁶⁸ Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(A).

²⁶⁹ US House of Representatives, *Report into the Insider Trading and Securities Fraud Enforcement Act* (1988) at 14-15.

the securities issuer recklessly disregarded the risk of illegal insider trading by its employees.²⁷⁰

2.203 Other organizations such as law or accounting firms or banks that regularly come into possession of material non-public information could also take preventative steps to minimise the possibility of insider trading abuse and any derivative liability. These steps could include prohibiting or controlling transactions in the securities of particular clients, internal reporting requirements for securities trading by partners or employees, and requirements that any securities trading be executed through a designated brokerage firm.²⁷¹

2.204 Under US law, a controlling person may also be jointly liable in any private civil suit brought against an insider trader “unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action”.²⁷² One commentator suggests that a controlling person may be liable if there has been a reasonably serious breakdown in (or the non-existence of) the sorts of controls that such a person should be expected to adopt to deal with the problem of insider trading.²⁷³

2.205 US brokers or investment advisers have an additional basis for derivative liability. They may be civilly liable for any insider trading or tipping breach by an employee where they knowingly or recklessly failed to establish, maintain or enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information, and that failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.²⁷⁴ This nexus between the failure of the supervisory system and the insider trading is established on proof that the breakdown or failure permitted or provided some assistance to the underlying violation.²⁷⁵

Advisory Committee view

2.206 Arguably, any organization that has inside information should have some responsibility to reduce the opportunities for its officers, partners or employees to trade on their own behalf while aware of inside information.

2.207 There is some evidence that, compared with the United States, Australian listed companies are less willing to introduce guidelines to prevent insider trading by

²⁷⁰ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.03[1][b] at 12-12 to 12-16.

²⁷¹ id, §12.03[2] & 12.03[3] at 12-27 to 12-34.

²⁷² Insider Trading and Securities Fraud Enforcement Act 1988 s 20(a).

²⁷³ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.03[1][c] at 12-16 to 12-21.

²⁷⁴ Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(B). The elements of this statutory requirement are analysed in D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.05 at 12-39 to 12-44.

²⁷⁵ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §8.02[2][c] at 8-23.

their directors and officers.²⁷⁶ Derivative civil liability may encourage Australian companies to act more decisively in this respect.

2.208 An argument against derivative civil liability is that it may reduce any incentive for firms to voluntarily notify the regulator and assist in the investigation of possible insider trading within their organizations, given a concern that the regulator may subsequently commence a derivative liability action against them.

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

Takeovers

Bidders

The issue

2.209 Should a member of a consortium which is secretly contemplating a takeover bid be entitled to transact in target company shares, with the consent of all other consortium members, if that member's only inside information is the takeover intentions of the consortium?

Australian law

2.210 A person who intends to conduct a takeover bid can acquire shares in the target company prior to announcing the bid, given the statutory exemption for a person's own intentions.²⁷⁷ However, this exemption does not permit a member of a

²⁷⁶ Bettis, Coles and Lemmon, "Corporate policies restricting trading by insiders", *Arizona State University Working Paper* (1998) found that 90% of respondents to a survey of US corporations (response rate 35%) had corporate policies regarding insider trading and 80% had instituted specific blackout periods, that is, periods where trading by executives and officers in the company's securities was prohibited.

By contrast, I Ramsay and R Hoad, "Disclosure of Corporate Governance Practices by Australian Companies" (1997) 15 *Company and Securities Law Journal* 454 report only a "small number" of 268 Australian companies they studied disclosed guidelines in their Annual Reports with respect to trading by directors and officers. "Some companies provided more specific guidelines and stated that their directors are permitted to buy and sell shares only during specified periods of time" (at 464).

A more detailed University of Western Australia study, Wan and Watson, *University of Western Australia Working Paper* (2000), examined the implications of the 1996 Australian Stock Exchange Listing Rule 4.10.3, which requires listed companies to include in their annual report a statement of the main corporate governance practices they employ. The study sample consisted of 311 companies (of the top 500) that had annual reports available for each of the years from 1995 to 1998. With respect to directors' share dealings, in 1995 only 7% (22 of 311 companies) reported guidelines with respect to the purchase/sale of the company's shares by directors, most stating only that directors are prohibited from insider trading. Since 1995 the number of companies has increased, to 20.3% (63 companies) in 1996, 21.9% (68 companies) in 1997 and 32.2% (100 companies) in 1998. The level of detail covered in these reports also increased over the same time.

²⁷⁷ ss 1002P (a natural person's own intentions), 1002Q (intentions of a body corporate) and 1002R (exception for officers or agents of a body corporate).

I Renard and J Santamaria, *Takeovers and Reconstructions in Australia* (loose leaf, Butterworths) at para [617] point out that "where the acquirer is part of a corporate group, care should be taken

takeover bid consortium to acquire shares before the consortium bid becomes publicly known, given that the exemption only applies to one's own intentions, not those of fellow consortium members (assuming that the knowledge that other consortium members are engaged in confidential takeover discussions constitutes confidential price-sensitive information).

Advisory Committee view

2.211 Individual consortium members should not be given an exemption from the insider trading provisions to acquire shares unilaterally. Any exemption for pre-bid buying should only apply to purchases made on behalf of the consortium collectively.

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

Target company directors

The issue

2.212 The principles underlying the Australian takeover provisions recognise the advantages to shareholders of an auction for target company shares. Directors of target companies who are aware of a pending hostile takeover bid may approach a third party (a white knight) to encourage that person to conduct a counter takeover bid or, at least, to acquire sufficient securities to force a substantial increase in the bid price. Do the insider trading provisions unduly inhibit these strategies?

Australian law

Subscribing for new shares

2.213 On one view, target company directors may lawfully provide inside information to white knights to encourage them to subscribe for new target company shares, in reliance on the case law that the insider trading provisions do not apply to a company issuing its own securities.²⁷⁸ In any event, the equal information defence would apply where a white knight has been given all relevant inside information by the target company directors prior to the subscription (given that the parties to the transaction are the white knight and the company).²⁷⁹

Purchasing issued shares

2.214 Another option for white knights is to purchase the target company's issued shares from existing shareholders. Target company directors who disclose inside information with this purpose or possibility in mind face two possible grounds of insider trading liability, namely:

to ensure that the entity which buys target shares before making the bid is the same entity which makes the bid as ss 1002Q and 1002R only apply where the acquirer is the same entity". This commentary also points out that "the exemption in s 1002R does not extend to purchases by officers and other associates of the offeror made on their own account".

²⁷⁸ *Exicom Limited v Futuris Limited* (1995) 18 ACSR 404.

²⁷⁹ s 1002T(2)(b).

- *disclosing inside information*.²⁸⁰ Typically, the type of inside information given to a white knight would be that there is a pending hostile takeover bid (if this information is not known to the market) and/or information that is exempt from the continuous disclosure requirements, such as information generated for internal management purposes only, for instance, projected financial data
- *procuring trading* when aware of inside information.²⁸¹

2.215 The equal information defence would not apply in these cases, given that the white knight would be purchasing shares from uninformed third party shareholders, not from the target company itself.

2.216 The courts have expressed some reluctance to intervene in this situation.²⁸² Nevertheless, target company directors may seek to better protect themselves by obtaining an undertaking from a white knight not to acquire any issued target company shares (or procure another person to do so) until all the relevant confidential price-sensitive information given by them to the white knight has been publicly disclosed.²⁸³ However, a white knight is not obliged to give that undertaking. Furthermore, one commentary has suggested that the mere initial disclosure to the white knight of any inside information prior to receiving an undertaking could breach the procuring provision, as it could be construed as encouraging the white knight to purchase target company shares immediately.²⁸⁴ That commentary points out that “in practice, target directors appear to ignore this problem, perhaps on the basis that inducing others to buy shares is beneficial to all shareholders apart from the offeror”.²⁸⁵

²⁸⁰ See para 1.85.

²⁸¹ See paras 1.93-1.95.

²⁸² For instance, in *ICAL v County Natwest Securities Aust Ltd* (1988) 13 ACLR 129, the Court declined to grant an injunction restraining target company directors from disseminating price-sensitive information to third parties with a view to soliciting a rival takeover bid. Bryson J stated that:

“I do not consider that it would be wise to make use of the remedy of an injunction against a company or directors of a company when the supposed insider trading was in fact an exercise undertaken, as this one appears to me to have been, with a view to widening the area of interest in the shares of the company in response to a takeover offer, a measure which is obviously in the interests of shareholders. Generally promoting interest in shares and competition with the offeror is an activity on which, in my view, a high value should be placed and I am reluctant to restrain it by injunction” (at 167).

²⁸³ The prohibition on disclosing inside information (s 1002G(3)) requires that “the insider knows, or ought reasonably to know” that the recipient of the inside information “would or would be likely to” transact in the affected securities. The target company directors could argue that, given the undertaking, they ought not reasonably to have known that the recipient of the information would be likely to deal in the securities.

The prohibition on recommending or encouraging transactions (s 1002G(2)(b)) prohibits an insider from “procuring” another person to transact in the affected securities. The target company directors could argue that, given the undertaking, they did not procure (as defined in s 1002D(2) to cover inciting, inducing or encouraging an act) the recipient to deal in the securities.

²⁸⁴ I Renard and J Santamaria, *Takeovers and Reconstructions in Australia* (loose leaf, Butterworths) at para [1149]. Under s 1002D(2), procuring includes inciting, inducing or encouraging an act or omission by another person.

²⁸⁵ Ibid.

Advisory Committee view

Subscribing for new shares

2.217 The Advisory Committee elsewhere proposes that the insider trading provisions apply to a company issuing its own securities. However, target company directors could still issue new securities to white knights who had been fully informed of all relevant inside information, given the equal information defence.

Purchasing issued shares

2.218 The Committee sees the need to integrate, if possible, the respective goals of the insider trading provisions and the takeover provisions. The Committee supports the policy of encouraging an auction for target company shares, where possible. Target company directors should have appropriate flexibility to promote this process. However, this should not extend to giving target company directors a free hand to encourage white knights armed with inside information to enter the market and purchase issued shares from uninformed counterparties.

2.219 One possibility is for the legislation to recognise corporate best practice by providing an express defence for target company directors who can show that:

- they communicated any inside information merely for the purpose of encouraging a person to act as a white knight, and
- they took all reasonable steps to ensure that the white knight did not purchase target company shares from uninformed existing shareholders before that information became generally available.

These two restrictions would be necessary to reduce any opportunities for abuse of an exemption that would permit a company to provide unequal access to its confidential information. A rule that goes some way towards satisfying the second restriction is found in the UK civil regime.²⁸⁶

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

White knights

The issue

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

²⁸⁶ UK Financial Services Authority Code of Market Conduct April 2001, Annex B, para 1.8.5 provides that a person holding inside information who lawfully discloses that information to a recipient should at the same time give the recipient a statement that the information is given in confidence and that the recipient should not transact on the basis of that information until it is made generally available.

Awareness of pending hostile bid not known to the market

Australian law

2.221 Intending bidders may lawfully buy shares in a target company before their own bid becomes publicly known, provided they have no other confidential price-sensitive information.²⁸⁷

2.222 A white knight who has been advised by target company directors of an undisclosed impending hostile takeover bid is caught by the insider trading provisions. The statutory exemption for knowledge of one's own intentions does not apply to awareness of some other person's intentions. The white knight would be prohibited from purchasing the target company's issued shares where the information about the hostile takeover bid was confidential and price-sensitive.

Advisory Committee view

2.223 The Advisory Committee acknowledges that, in some instances, the current prohibition could inhibit white knights acquiring target company shares, and therefore reduce the possibility of a takeover bid auction in those shares. However, the Committee does not support any statutory exemption that would permit white knights to purchase shares from uninformed counterparties.

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

Awareness of other inside information

Australian law

2.224 A white knight who has been given other inside information by the target company directors cannot purchase any issued shares prior to that information becoming generally available.

Advisory Committee view

2.225 The Advisory Committee acknowledges that the current prohibition could significantly reduce the ability of white knights to purchase a strategic share parcel in the pre-bid period sufficient to encourage an auction. Nevertheless, it does not support any statutory exemption for purchases by white knights. The Committee would be concerned about any exemption that would permit white knights to transact with uninformed counterparties while in possession of inside information, even if given by the target company to encourage a counter-bid or improve the hostile bid offer price.

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

²⁸⁷ s 1002P.

Chapter 3

Remedies

This Chapter examines the remedial powers of regulators over insider trading and the compensation rights of affected persons. The question of whether, or to whom, compensation should be paid by insiders, and how that compensation should be assessed, arises particularly with on-market trading.

Regulator's remedies

The issue

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

Australian law

3.2 Breach of the insider trading provisions is a criminal offence subject to imprisonment and/or a fine. In addition, orders may be sought under the Proceeds of Crime Act 1987 (Cth) and the Crimes Act 1914 (Cth) to deprive an insider of any benefits received as a result of the insider trading, and for the insider to pay reparation to any affected person. The court has various restraining, disposal and vesting powers to deal with the consequences of insider trading.²⁸⁸

3.3 ASIC may, in the public interest, bring a civil action in the name of a body corporate whose securities have been traded to recover amounts that the body corporate is entitled to recover under the legislation.²⁸⁹ It may also seek injunctive and related relief,²⁹⁰ or request the court to exercise any of its broad discretionary powers, for instance, to order that the insider pay compensation to aggrieved persons, or to permit these persons to avoid their contracts with the insider.²⁹¹ The Commission may also enter into enforceable undertakings, whereby a person agrees to do or refrain from doing a particular action.²⁹²

3.4 Under the Financial Services Reform Bill, the insider trading provisions will be civil penalty provisions,²⁹³ with the court having the power to make various civil penalty orders including:

- a declaration of contravention²⁹⁴
- a pecuniary penalty order of up to \$200,000,²⁹⁵ or

²⁸⁸ s 1002U.

²⁸⁹ s 1013(6), ASIC Law s 50.

²⁹⁰ ss 1323, 1324, 1325.

²⁹¹ s 1114.

²⁹² ASIC Act s 93AA.

²⁹³ s 1317E(1)(jf), (jg).

²⁹⁴ ss 1317E(1), (2), 1317F.

- a compensation order for any person who has suffered damage through a contravention.²⁹⁶

Only ASIC may apply for a declaration of contravention or a pecuniary penalty order.²⁹⁷

3.5 Proceedings for a declaration of contravention or a pecuniary penalty order must be started no later than six years after the contravention.²⁹⁸

3.6 To guard against double jeopardy, proceedings for a declaration of contravention or a pecuniary penalty order are stayed if there are criminal proceedings for the same conduct.²⁹⁹

Overseas law

3.7 Most of the jurisdictions discussed in this Paper permit the regulator to take civil, as well as criminal, action against insider traders.

3.8 Civil remedies against insiders include disgorgement of any profit obtained or loss avoided as a result of insider trading³⁰⁰ and a civil monetary penalty of up to three times the profit gained or loss avoided by an insider trader.³⁰¹

3.9 In the United States, the Securities and Exchange Commission (SEC) has the power to pay a bounty to informers of up to 10% of any penalty collected by the Commission.³⁰² The argument for this power is that it may assist the SEC to identify and investigate possible insider trading. The contrary argument is that bounty payments might frustrate firms' own internal compliance systems, in that individuals may hesitate to report suspicious conduct internally lest they lose the ability to claim a bounty.

3.10 The UK also gives the Financial Services Authority the power to impose financial administrative penalties. The grounds for imposing these financial penalties are designed to reflect market behaviour and expectations. The tests employed are different from those that impose criminal liability. The four prerequisites for administrative penalties are:

- the person must possess information that is not generally available to the market at large

²⁹⁵ s 1317G.

²⁹⁶ s 1317HA.

²⁹⁷ s 1317J(1), (4).

²⁹⁸ s 1317K.

²⁹⁹ s 1317N. The proceedings for the declaration or order can be resumed if the director is not convicted. Otherwise, the proceedings are dismissed.

³⁰⁰ United States, South Africa.

³⁰¹ United States, South Africa, Malaysia. The Monetary Authority of Singapore will have power to recover triple damages under the draft Securities and Futures Act 2001. The Canadian provincial securities legislation imposes a maximum fine of up to four times the profit made or loss avoided by reason of the contravention. In France, the maximum monetary penalty is ten times any profit realised on the insider trading.

³⁰² Insider Trading and Securities Fraud Enforcement Act 1988. Informers can include brokerage firms, which thus have an incentive to monitor the activities of their employees.

- the information would be likely to be regarded by a regular user in the market as relevant when deciding the terms on which transactions in investments of the kind in question should be effected
- the information must relate to matters which 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
- the person's behaviour must be based on the information, and not be required for other reasons.

Behaviour such as scalping, frontrunning or piggy backing may not be caught under these provisions, as the market would not expect information about clients to be made public.

Advisory Committee view

3.11 Under the Financial Services Reform Bill, ASIC will have the power to seek a civil penalty for insider trading. However, in the context of insider trading, the Committee seeks views on whether the civil penalty provisions should include a multiple factor for the profit gained or loss avoided. Any funds received (less administrative costs) could be disbursed to eligible claimants (see paras 3.24-3.43).

3.12 Given the current initiatives with civil penalties, it may be premature to consider further moves such as giving the regulator a power to impose administrative penalties or award a bounty. The Advisory Committee notes that the Australian Law Reform Commission is currently conducting a general review of civil and administrative penalties.

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

Persons civilly liable

Uninformed procured persons

The issue

3.13 Insiders, persons procured by insiders, and any other persons involved in the contravention may be civilly liable for insider trading. Should there be any exemption from civil liability for uninformed persons procured by insiders?

Australian law

3.14 An insider is civilly liable for insider trading, or procuring some other person to trade.³⁰³ Any person procured by an insider to transact in the securities is also civilly liable for the profit made or loss avoided by the transaction, even where the person procured is unaware of the inside information.³⁰⁴

³⁰³ ss 1005, 1013.

³⁰⁴ Any person procured is referred to as "the other person" in s 1013(2), (3), (4), (5).

Advisory Committee view

3.15 On one view, a counterparty to any transaction that was directly or indirectly tainted by insider trading should have a right to compensation. However, extending civil liability beyond insiders to persons procured by insiders could produce a harsh result where the persons procured acted in good faith, without knowledge of the inside information, and expected to achieve a final settlement.³⁰⁵ Arguably, these persons should not be civilly liable to disgorgement in those circumstances, given that the legislation provides civil remedies against insiders who procure others to trade.

3.16 To avoid possible abuse by insiders (for instance, using uninformed relatives or associates to trade), any exemption from civil disgorgement liability for persons procured could be limited to circumstances where the person procured was not aware of the inside information and the insider who procured did not receive any direct or indirect benefit from the transaction. The person procured could have the onus of proving both these elements.

3.17 Any civil liability for uninformed procured persons should be limited to the actual profit made or loss avoided by them. Given that they are not insiders, they should not be subject to any multiple civil penalty.

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

Equal information defence

The issue

3.18 Should insiders (or persons procured) have a statutory equal information defence in civil proceedings similar to the defence that applies in criminal proceedings?

Australian law

3.19 Insiders have a specific defence to a criminal prosecution if the court is satisfied that the counterparty to the transaction “knew or ought reasonably to have known” of the confidential price-sensitive information.³⁰⁶

3.20 There is no equivalent statutory civil defence. However, civil liability of an insider to a counterparty requires that the counterparty “did not possess the information”.³⁰⁷ In effect, this creates an equal information defence where the counterparty has actual knowledge. The defence appears not to apply, however, where the counterparty did not know, but ought reasonably to have known, of the relevant information.

³⁰⁵ This concern was also raised in the New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (November 2000), paras 166-167.

³⁰⁶ s 1002T(2)(b).

³⁰⁷ s 1013(3) (4).

3.21 There is no equal information defence in civil actions involving transactions between an insider who subscribes for shares and the issuing company.³⁰⁸ However, where the company as well as the subscriber is aware of the inside information, the company may have no common law remedy. Equality of information between contracting parties is recognised as a defence in contract law. The legislation does not appear to overturn that common law principle.

3.22 A company whose securities are traded, but which is not a party to the transaction, may also have civil remedies.³⁰⁹ In this context, a counterparty equal information defence is irrelevant, as the company is not a transacting party.

Advisory Committee view

3.23 The same principles should apply in criminal and any civil proceedings. In either instance, there should be a defence that the counterparty to the transaction “knew or ought reasonably to have known” of the confidential price-sensitive information.

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

Persons entitled to compensation

Market participants

The issues

3.24 Who, if anyone, should be entitled to compensation for insider trading? How should any compensation be assessed?

Australian law

Eligible claimants

3.25 A counterparty to a person trading when aware of inside information has standing to sue for damages or other related remedies.³¹⁰ Also, ASIC may request a court to compensate counterparties.³¹¹

³⁰⁸ s 1013(2).

³⁰⁹ s 1013(5).

³¹⁰ Most of the recent Australian private insider trading civil litigation has arisen in the context of a commercial dispute, rather than a claim for compensation. For instance, in *Crafter v Singh* (1990) 2 ACSR 1, the defendant sought to avoid a contract to purchase shares on the ground that the counterparty had engaged in insider trading. In *Exicom Limited v Futuris Limited* (1995) 18 ACSR 404, a person sought to use an alleged breach of the insider trading provisions to restrain a second person from proceeding with an agreement to make a share placement to a third person in the context of a battle for corporate control of the second person. In *Ampolex Ltd v Perpetual Trustee Company (Canberra) Ltd* (1996) 20 ACSR 649, the allegation of insider trading arose in the context of a wider dispute regarding the conversion rate to be applied to certain convertible securities. In that case, Rolfe J came to the tentative conclusion that s 1005 and s 1013 do not provide separate causes of action. Rather, they must be read together. Therefore, before a civil action can be brought under s 1005 for a contravention of the insider trading provisions, the requirements in s 1013 for bringing such a civil action must be

3.26 A counterparty in any off-market face-to-face transaction is readily identifiable. However, market participants may face considerable privity and identification difficulties in determining whether they were the counterparty to an insider (or a person procured) who has traded on-market. One commentary points out that:

“In the case of sales and purchases on-market, proof of contractual privity will almost always be difficult and will sometimes be impossible. There are several difficulties. One is that on some occasions a broker acting as principal (not merely as deemed principal) will stand between the plaintiff and the contravening defendant. Another is that the process of allocation of on-market transactions to clients is normally carried out in the back offices of the buying and selling brokers, who appear to have a discretion to set policies for the process of allocation (ASX Listing Rule 3.3). Further, the allocation may be carried out on a net basis, at least where institutional clients are involved. The result may be that, particularly where there has been active trading, the plaintiff will be unable to demonstrate contractual privity with the defendant even if all of the labyrinthine facts are before the court.”³¹²

Assessment of compensation

3.27 An insider (or a person procured) has a maximum potential civil liability of the actual profit made, or loss avoided, through the relevant trading. This is determined (except in the case of options) by the difference between the transaction price and the notional price if the inside information had been generally available at the time of trading.³¹³ There is no provision for multiple damages.

Overseas law

Eligible claimants

3.28 Various overseas jurisdictions go beyond direct counterparties to include “contemporaneous traders” within the category of eligible claimants.

3.29 Contemporaneous traders are not confined to persons who have been matched with an insider on-market. The concept is designed to include all 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. This overcomes the problem of random matching of buy and sell orders on an anonymous market.

established. In a civil action under these provisions, it is sufficient for the innocent party to show, on the balance of probabilities, that a contravention has occurred: s 1332.

³¹¹ s 1114.

³¹² HAJ Ford, RP Austin & IM Ramsay, *Ford's Principles of Corporations Law* (loose leaf, Butterworths) at [9.690].

³¹³ s 1013(2)-(5). The test is the difference between the cost of the securities subscribed for, purchased or sold by the insider and the price at which they would have been likely to have been sold or purchased in a transaction made at that time if the information had been generally available.

3.30 The US legislation adopts, but does not define, contemporaneous trading. This was intentionally left for the courts to develop in light of changing market practices and trading technologies. Some commentators suggest that, in a widely traded security, contemporaneous trading would be any trading that takes place within a few days of the insider's trading activities, though some case law suggests that trading would have to take place within one day of those activities to be contemporaneous.³¹⁴ It is unclear whether a person who trades immediately before the insider's unlawful trading has standing to sue. One judicial view is that any person who trades before the insider, even on the same day, has no cause of action, as an insider commits no wrongdoing until he or she begins dealing in securities.³¹⁵

3.31 The American Law Institute draft Securities Code (which is a model Code only) has the broadest test of contemporaneous trading. It classifies as eligible claimants any person:

“who buys [or sells] during the period beginning at the start of the day when the [insider trader] first unlawfully sells [or buys], and ending at the end of the day when all material facts ... become generally available”.³¹⁶

3.32 One commentator on the Singapore legislation, which employs the contemporaneous dealing concept, has suggested that these dealings should be confined to trades entered into on the same day as the insider dealing, whether before or after the time that the insider dealing took place.³¹⁷ Arguably, including all same-day traders could avoid possible arbitrariness arising from the order in which clients' instructions are executed.

3.33 South Africa, in the context of civil recovery by the Financial Services Board, specifies persons to whom amounts recovered are payable as:

- where the inside information was made public within a week of the insider having traded - any persons who dealt within that week in the same securities or financial instruments on the opposite side of the market to the insider
- if the time lapse was more than a week - any persons who dealt in the same securities or financial instruments on the opposite side of the market to the insider on the same day (whether before or after the time) that the insider traded.³¹⁸

³¹⁴ M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 31, D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §9.02[1] at 9-9, L Loss and J Seligman, *Securities Regulation* (3rd edn, Little, Brown & Company) vol VIII at 3724.

³¹⁵ *O'Connor & Associates v Dean Witter Reynolds Inc* 745 F.Supp. 1511 (1990). See further D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §9.02[2] at 9-10.

³¹⁶ American Law Institute Draft Federal Securities Code §1703(b). VM Dougherty, “A[dis]semblance of Privity: Criticizing the Contemporaneous Trader Requirement in Insider Trading” 24 *Delaware Journal of Corporate Law* 83 (1999) supports this approach.

³¹⁷ Tan Cheng Han, “Protecting the integrity of the securities market: recent amendments to the law relating to insider trading” [2000] *Singapore Journal of Legal Studies* 33 at 46.

³¹⁸ South African Insider Trading Act 1998 s 6(6).

There is no requirement that these persons prove actual loss.

Assessment of compensation

3.34 Various jurisdictions provide that any money recovered by the regulator in civil actions against an insider, which can include a multiple of the profit gained or loss avoided, (less reasonable expenses) shall be held for the benefit of eligible claimants.

3.35 In assessing compensation to each eligible claimant, the Canadian provincial securities legislation 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.

These factors seek to provide an objective compensation formula, while avoiding the effects of immediate, and possibly inappropriate, market reaction when inside information is first disclosed.

Advisory Committee view

Should there be rights of compensation?

3.36 An argument against granting any compensation rights, particularly to on-market participants, is that it is difficult to discern what actual loss they have suffered. Presumably, they would have traded with other market participants if the insider had not been in the market. Arguably, the only time when a person’s loss can be directly linked to a transaction with an insider is when it involves a face-to-face off-market transaction between that person and the insider or when the insider is the only person making a market on one side of the trade, so that without the insider no-one would have transacted.

3.37 A contrary argument is that permitting traders to obtain compensation helps ensure that insiders do not profit from their illegal behaviour. Also, market participants are entitled to expect that any person with whom they transact does not have an unerasable advantage through access to price-sensitive information not available to the market generally and that they will have rights to compensation if this is not the case. Furthermore, since the information on which an insider trades is materially price-sensitive, market traders would have altered their trading conduct (for instance, not trading or trading on different terms) had the information then been generally available.

Who should be eligible claimants?

3.38 To confine claimants to those persons who have been matched with an insider (or person procured) could have anomalous effects for transactions on an anonymous exchange, particularly if there are other persons transacting in the same manner, and at the same time, as the insider. It would then be a random matter whether a particular trader is matched with the insider or some other person. As one commentator has noted:

“To give a civil remedy to the person who happened to end up with the insider’s shares and not to the others who dealt in the market at the same time in the security in question would be arbitrary, whilst to give a civil remedy to all relevant market participants might well be oppressive of the insider.”³¹⁹

3.39 The concept of contemporaneous dealing would overcome the problems of privity, identification and chance in determining who has standing to sue, while still confining the category of eligible claimants. There are various possible contemporaneous dealing tests, as reflected in the US and South African legislation.

3.40 Another, and even broader, contemporaneous dealing test, as reflected in the American Law Institute draft provisions, would be everyone who has traded on the opposite side of the market to the insider in the period between the insider trading and the release of the price-sensitive information. Arguably, all these persons have been equally disadvantaged by the non-disclosure of the inside information. However, this broader test could result in an excessively large number of eligible claimants, and thereby only a minuscule return to each claimant, even if the money recovered from the insider for distribution to those claimants were a multiple of the profit gained or loss avoided by the insider.

3.41 The Advisory Committee seeks comments on the relative merits of each of these tests.

How should compensation be assessed?

3.42 Arguably, any money recovered in civil penalty actions by the regulator from an insider trader (less reasonable administrative expenses) could be made available to eligible claimants.

3.43 The Canadian “average market price” approach provides one means to determine compensation for eligible claimants without the possible complexity or uncertainty that could arise under the Australian provision in determining a notional price for which the securities would have been traded if the inside information had been generally available when the insider trading took place. However, the 20 day period following general disclosure of the inside information under the Canadian test may be too long. Also, it does not take into account other factors that may affect the market price between the insider trading and the expiration of the 20 day post-disclosure period.

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

³¹⁹ Gower’s *Principles of Modern Company Law* (Sweet & Maxwell, 6th Edition, 1997) at 457.

Companies whose securities are traded

The issue

3.44 Should a company whose securities are traded in breach of the insider trading provisions be entitled to compensation?

Australian law

3.45 These companies have standing to seek civil remedies. They may recover for any profits made or losses avoided by insiders (or persons procured) in any transactions involving their securities, even where they are not the counterparties to those transactions.³²⁰ Individual shareholders might seek to act on behalf of the company through a statutory derivative action (for instance, where the insiders are the directors of the company, and therefore are unwilling to have the company commence an action against them).³²¹

3.46 In addition, ASIC may, in the public interest, bring a civil action in the name of a body corporate whose securities have been traded to recover amounts that the body corporate is entitled to recover under the legislation.³²²

Overseas law

3.47 New Zealand and Canada³²³ permit the company whose securities were traded to seek civil remedies.

3.48 Under the New Zealand law, the company whose securities were traded or, with the leave of the court, any person who was a shareholder of that company at the time the insider trading took place may take civil proceedings against an insider.³²⁴ The maximum recoverable fund cannot exceed the consideration paid for the securities or three times the profit made or loss avoided by the insider, whichever is the greater.³²⁵

3.49 Any money recovered in an action by the company must be held for distribution in accordance with the directions of the court. The court may order that any amount be distributed to particular individuals (such as shareholders or former shareholders of the company or any person who would otherwise have a civil remedy against the insider), be retained by the company or be paid for charitable purposes.³²⁶

Advisory Committee view

3.50 The argument for granting civil remedies to companies whose securities are traded is that, in many instances, the insider has used the company's valuable commercial intellectual property, which may have been developed at great expense

³²⁰ s 1013(2), (5).

³²¹ ss 236 ff.

³²² s 1013(6), ASIC Law s 50.

³²³ Ontario Securities Act s 134(4).

³²⁴ New Zealand Securities Amendment Act 1988 ss 7(2)(c), 9(2)(g), 11(2)(c), 13(2)(g), 18.

³²⁵ id, ss 7(4), 11(4).

³²⁶ id, s 19.

for the purpose of pursuing a strategic interest, increasing profitability or preserving a competitive advantage. The use of this information by insiders could therefore be analogous to theft from the company. In addition, failure to recognise a company's proprietary right in its inside information by not conferring a statutory right of civil recovery may discourage or significantly reduce some corporate investment in the search for and production of valuable information.

3.51 The opposing argument is that, in most instances, any harm caused by insider trading is borne by the counterparties to the insider, or the market generally, rather than the company whose securities were traded. That company would not be a party to most affected transactions, and could therefore obtain a windfall under this provision, given that it has not suffered any direct harm or loss.³²⁷ In only very limited instances would a company suffer an actual loss through insider trading in its own

³²⁷ The following examples may be given.

Commercial contract. A corporate officer negotiates a major contract for the company and, prior to its announcement, purchases some of the company's shares in anticipation of the shares increasing in value through the announcement. The company does not suffer any loss of profits or other loss from that transaction. For instance, that trading does not reduce the contract's value to the company. It is also difficult to argue that the company is acting on behalf of the affected counterparties to the insider, given that those counterparties may no longer be shareholders and, even if they were, would not benefit directly over and above any other shareholders from the recovery obtained by the company. At most, the company may suffer reputational damage from one of its officers acting illegally.

Unfavourable corporate information. An insider sells shares in anticipation of a company releasing unfavourable financial information. It is hard to justify a company recovering the losses avoided by the insider, given that any loss is borne solely by the purchasers of the shares.

Takeover bid. An officer of a prospective bidding company uses inside information about the forthcoming bid to trade in the target company's shares. The target company, not the bidder, will be entitled to recover under s 1013(5), notwithstanding that the officer may have breached his or her fiduciary duties to the bidder company, not the target, through use of this information. The bidder company may have a separate action against that officer under s 183.

shares.³²⁸ Also, there are civil remedies where any of a company's directors or officers improperly use its corporate information.³²⁹

3.52 The solution may be either to confine the provision to where the company suffers actual loss through insider trading or to retain the existing remedy, but give the court a discretion over the distribution of funds recovered by the company, as under the New Zealand legislation.

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

³²⁸ For instance, a company officer with inside information about a pending buy-back scheme might purchase a substantial number of the company's securities in anticipation of the announcement of the buy-back. If those purchases had caused a rise in the market price for the securities, the company could be detrimentally affected by having to pay more for its own shares.

³²⁹ s 183.

Chapter 4

Other provisions

This Chapter discusses various measures, in Australia and overseas, which complement the insider trading laws. The Australian requirement for directors of listed companies to notify holdings in their companies' securities needs to be considerably strengthened to make it more effective. The Canadian controls over speculative trading by company executives in their own companies' securities and the US "short swing profit" rule are raised for consideration in the Australian context.

Director notification of securities holdings

The issue

4.1 Directors and other senior company officers who fulfil their duties in a conscientious fashion will from time to time be aware of confidential information that could affect the price of their companies' securities. One means to reduce any opportunity for particular directors or senior officers to trade undetected when aware of inside information is to require that all directors and senior officers promptly disclose all trading in their company's securities. Are the existing statutory disclosure requirements satisfactory?

Australian law

4.2 Directors of a listed public company must notify the exchange of any changes in the relevant interests they hold in securities of that company or any related company.³³⁰

4.3 This statutory disclosure requirement has some apparent limitations. It:

- applies to listed companies, but not listed managed investment schemes. In consequence, directors of a responsible entity of a listed managed investment scheme are not obliged to notify any changes in their holdings in that scheme
- may not apply to directors of registered foreign companies listed on the ASX
- is limited to directors. One possibility is to extend the disclosure obligation to all executive officers or, at least, the top five executive officers (based on relative remuneration)³³¹

³³⁰ s 205G, s 9 definition of "relevant interest", ss 608, 609.

The genesis of s 205G can be found in the UK *Cohen Committee Report* (1945) (Cmnd 6649) para 86, which, in the context of considering insider trading, recommended legislation to ensure that transactions by a director in the securities of his or her company were made public.

³³¹ Section 9 defines an "executive officer" as "a person who is concerned in, or takes part in, the management of [a body corporate] (regardless of the person's designation and whether or not the

- requires disclosure of the information within 14 days of any change in interests. This period may be too long. A much shorter period, say 5 business days, may be more reasonable
- may not require persons who resign as directors to disclose any changes in their interests that had occurred in the 14 days before their resignation
- does not require directors to disclose the date on which their interests changed
- does not require the directors to indicate the nature of the change, such as whether the securities referred to have been sold or purchased. This information is only available by referring to the immediate prior lodged notice
- does not require the directors to indicate how the change in shareholding took place, for instance, under a dividend re-investment plan, through exercise of options or by an on-market or off-market transaction.

4.4 A company's annual report must disclose details concerning its directors' holdings of the company's shares or related options, but not other securities.³³²

4.5 The ASX proposes to amend its Listing Rules from September 2001 to require each listed entity to disclose, within five business days, any information of which it is aware relating to its directors' holdings of its securities and changes to those holdings, subject to a material change threshold.³³³

Advisory Committee view

4.6 The requirement for directors of listed companies to disclose their trading in their companies' securities reflects the market's legitimate interest in knowing the transactions of directors in their own company's securities. It also reduces the opportunity for any particular director to engage in insider trading without detection.³³⁴ In addition, some companies have "windows trading" policies, which

person is a director of the body)". Officer of a body corporate is defined much more broadly in s 9 and s 82A.

Listed companies must disclose in their annual reports details of the remuneration of each director and each of the five named officers of the company receiving the highest emolument: s 300A(1)(c).

³³² s 300.

³³³ Originally, the ASX proposed a notification period of two business days following a transaction. However, a large number of respondents argued that a two business day notification requirement was too short, given that orders to buy or sell at a particular price may result in trades being effected over a period of time. Also, directors may be overseas when transactions take place, or they may entrust their affairs to discretionary managers and not be aware that transactions have taken place. They may not be immediately advised of issues of securities under dividend re-investment plans or employee incentive schemes. The ASX subsequently revised the notification period to five business days after the date of any transaction.

³³⁴ Information from s 205G notices can be used to indicate the possibility that particular persons may be engaging in insider trading. Various research projects to this effect have been undertaken through the University of Western Australia, namely: P Brown and MS Foo, "Insider Trading in Australia: Evidence from Directors' Trades", ID Watson and A Young, "A Preliminary Examination of Insider Trading around Takeover Announcements in Australia", A Anand, "An

limit the times when directors and other officers can deal in their company's securities (for instance, for a period after release of the annual general report, when it is most likely that the market will be fully informed), though any dealing within the windows period is still subject to the insider trading laws.

4.7 The ASX's proposed Listing Rule requirement seeks to complement comprehensive disclosure obligations in the Corporations Law. However, the ASX can only impose the disclosure obligation on listed entities, given that the relevant contractual relationship is between ASX and the listed entity, not its individual directors. Listed entities may not necessarily know the transactions of their directors. Therefore, a comprehensive statutory disclosure obligation on directors is also necessary.

4.8 The director notification requirements should be made fully effective by amendments to overcome their identified limitations, as set out in para 4.3.

4.9 The annual report disclosure requirements should also be made more comprehensive to cover all securities, not just shares.

4.10 Currently, there is no Corporations Law prescribed form for director disclosure notices. In consequence, directors can include the required information among other information, where it may not be readily accessible. It would be useful if an appropriate tabular style form were included in the Corporations Law Schedules. That form could prominently indicate the date of the change, current holdings and changes to previous holdings and the nature and origin of these changes. Directors could also be required to disclose this information immediately on their company's website.

4.11 The Advisory Committee notes the discussion in the ASX Listing Rule amendment proposal whether to introduce a material change threshold to trigger the notification requirement. For instance, substantial shareholders must lodge a notice only where there has been a 1% change since their last notification.³³⁵

4.12 The Committee does not favour a material change threshold. Notification of all changes is not unduly burdensome, and the market has a legitimate interest in knowing immediately of directors' dealings in the securities of their own companies. Also, any threshold could result in particular directors engaging in insider trading in small quantities of their company's securities, with no obligation to disclose and therefore a lower chance of detection. Furthermore, the substantial shareholding provisions are aimed only at alerting the market to changes in corporate control and therefore do not require the notification of minor transactions in shares.

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

³³⁵ investigation of long-run performance and insider trading in Australia", B Baker, "The Information Content of Earnings and Director Trading Activity".
s 671B.

Speculative trading by corporate decision makers

The issue

4.13 Should there be controls over “speculative trading” by directors and other corporate decision makers in the securities of their companies?

Australian law

4.14 There is no specific provision dealing with speculative trading.

Overseas law

4.15 In addition to the insider trading provisions, the Canadian legislation prohibits two forms of speculative trading by company directors, officers and other persons closely connected with a company (closely connected persons), namely:

- short selling their company’s shares
- transactions in call or put options over their company’s shares.

These prohibitions are seen as extensions of, or complementary to, the insider trading provisions. However, there is no requirement that these persons have any inside information.

4.16 Closely connected persons are prohibited from short selling their company’s shares or those of an affiliate company.³³⁶ It has been argued that short selling by these persons is simply pure speculation by them that the price of their company’s shares will decline in the short term. This may create a conflict between their personal interests and the company’s interests, particularly where they are in a position to influence the company’s affairs. Permitting short selling may also encourage insider trading where closely connected persons are aware of confidential information, the release of which will reduce the market price of the company’s shares.³³⁷

4.17 Closely connected persons are also prohibited from selling or buying a call or put option over their company’s shares or those of an affiliate company.³³⁸ This prohibition reflects a policy that those persons should not be allowed to speculate in their company’s shares or place their personal interest above the interests of their company.³³⁹ In some instances, these persons could have inside information.

³³⁶ Canada Business Corporations Act s 130(1), (3).

³³⁷ Industry Canada, *Insider Trading Discussion Paper* (February 1996) at para [68], quoting from materials prepared for the Canadian Parliament in 1970 explaining the policy rationale behind the prohibition on short sales by insiders in the Canada Business Corporations Act s 130(1).

³³⁸ Canada Business Corporations Act s 130(2).

³³⁹ Industry Canada, *Insider Trading Discussion Paper* (February 1996) paras [68]-[72].

4.18 Various amendments to the Canadian speculative trading provisions have been proposed, namely that:

- the prohibition on short selling and entering into option contracts should be extended beyond shares to all securities
- the category of closely connected persons should be limited to persons who can influence corporate decision-making (and who are therefore more likely either to have access to inside information or to be able to use their decision-making power to promote their personal interests over the company's interests), and
- the prohibition on options should be limited to those options where a closely connected person would benefit from a decline in the value of the company's shares. By contrast, a prohibition on options where a closely connected person would benefit from an increase in the value of the company's shares is unnecessary, as it would not further the objective of eliminating conflicts.³⁴⁰

Advisory Committee view

4.19 The Canadian speculative trading provisions seek to deal with certain types of trading in a company's shares by persons closely connected with that company. This matter may be better dealt with under the principles governing the prohibition on short swing profits (post).

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

Prohibition on short swing profits

The issue

4.20 Should there be a "short swing profit" prohibition?

Australian law

4.21 There is no specific provision dealing with short swing profits.

Overseas law

4.22 The US legislation gives an issuer of securities (or a shareholder of the issuer in a derivative action) the right to seek recovery of any profits made by any corporate directors, executive officers or substantial shareholders (that is, persons who are beneficial owners of more than 10% of any class of equity securities) of that issuer

³⁴⁰ Industry Canada, *Insider Trading Discussion Paper* (February 1996) paras [65]-[87], Appendix A. These proposals are contained in the Canada Business Corporations Act Amendment Bill (March 2000).

from any purchase and sale (or sale and purchase) of the issuer's equity securities (or securities convertible into equity) in any six month period ("short-swing profits").³⁴¹

4.23 This legislation works on a prima facie presumption that directors etc are likely to have inside information and therefore any purchases and sales by them within a six month period are entered into while aware of that information. This provision therefore reduces the opportunities for such persons to gain from inside information. However, it applies whether or not the director, officer or substantial shareholder in fact possessed any inside information. Civil liability is triggered simply by finding both a purchase and sale (or sale and purchase) of securities within the statutory six month period.

4.24 Various exemptions have been introduced to reduce the potential overreach of the provision. For instance, the SEC has exempted stock option and stock ownership plans. Without this protection, various acquisitions and sales of a company's securities by corporate executives pursuant to these plans would be affected.³⁴² Likewise, the courts have granted exemptions for involuntary transactions, such as purchases and sales effected under a hostile takeover bid.³⁴³

4.25 The US provision is seen as a partial adjunct to their insider trading laws. It only applies to directors, officers and substantial shareholders, not other persons within a company who may have access to confidential price-sensitive information. Also, it only applies to trades within a six month period.

4.26 Enforcement depends on the willingness of the issuer (or a shareholder in a derivative action) to bring an action. There is no public enforcement. Any private action must be brought within two years of when the affected transaction was disclosed.

Advisory Committee view

4.27 Directors or senior executives who engage in short swing trading in their own company's securities may be acting contrary to corporate governance best practice. The question is whether there should be statutory constraints on this activity.

4.28 The US strict liability rule is based on the presumption that a company's directors and executive officers, if diligently fulfilling their duties, are likely to have inside information and should therefore be constrained from short-term dealing.

4.29 Arguably, any adoption of this rule in Australia should be limited to directors and executive officers, given that substantial shareholders who do not have board representation may not necessarily be better informed than other shareholders. The Australian law has separate disclosure provisions for substantial shareholders.³⁴⁴

4.30 A related question is whether any persons other than the company itself and its shareholders should have rights of recovery.

³⁴¹ Securities Exchange Act s 16(b).

³⁴² SEC Rule 16b-3.

³⁴³ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §10.02[2][a] at 10-15 ff.

³⁴⁴ s 671B.

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

Appendix 1

Financial Services Reform Bill comparison

Corporations Law	Financial Services Reform Bill	Relevant differences
s 1002A	s 1042A	Bill applies to financial products, including derivatives and superannuation products
s 1002	s 1042B	Nil
s 1002B	s 1042C	Nil
s 1002C	s 1042D	Nil
s 1002D(1)	s 1042E	Nil
s 1002D(2)	s 1042F	References to Crimes Act and Criminal Code in s 1042F(2)
s 1002E	s 1042G	Substitution in FSRB of “recklessness” for “ought reasonably to know”
s 1002F	s 1042H	Substitution in FSRB of “recklessness” for “ought reasonably to know”
s 1002G	s 1043A	Substitution in FSRB of “recklessness” for “ought reasonably to know” s 1043A is a civil penalty provision
s 1002H	s 1043B	Nil
s 1002J	s 1043C	Nil
s 1002K	s 1043D	Nil
s 1002L	s 1043E	Nil
s 1002M	s 1043F	Nil
s 1002N	s 1043G	Nil
s 1002P	s 1043H	Nil
s 1002Q	s 1043I	Nil
s 1002R	s 1043J	Nil
s 1002S	s 1043K	Nil
s 1013	s 1043L	FSRB refers to a civil action under s 1317HA
s 1002T	s 1043M	Application of an evidential burden on the defendant under s 13.3(3) of the Criminal Code
--	s 1043N	New relief from civil liability provision
s 1002U	s 1043O	Nil

Appendix 2

European Union model

The European Union (EU) in 1989 adopted Council Directive 89/592 *Co-ordinating Regulations on Insider Dealing* (EU Directive), for implementation by the EU Member States in their respective national laws.

What is inside information

The EU Directive defines inside information as:

“any information of a precise nature relating to one or more issuers of transferable securities or to one or several transferable securities which has not been made public, but which if it were made public, would be likely to have a significant effect on the price of the transferable security or securities in question”.³⁴⁵

The “precise nature” element was designed to ensure that the definition would not cover rumours and speculation.

Who are insiders

The EU Directive distinguishes between primary and secondary insiders.

Primary insiders. The Directive defines primary insiders by a specific causal link between the person and the source of the information. A primary insider is “any person who:

- by virtue of his membership of the administrative, management or supervisory bodies of the issuer (of the securities to which the inside information relates),
- by virtue of his holding in the capital of the issuer, or
- because he has access to such information by virtue of the exercise of his employment, profession or duties,

possesses inside information”.³⁴⁶

There is no threshold requirement for persons holding capital in the issuer. Accordingly, any shareholder possessing inside information could, in principle, be a primary insider. However, the causal link (“by virtue of”) between the information and the position as a shareholder makes it unlikely that shareholders with a small percentage of the capital of an issuer would have the information by virtue of their holdings. Instead, this category would apply to persons who, through their

³⁴⁵ EU Directive, Article 1.

³⁴⁶ id, Article 2.

shareholding, have special contacts with the issuer and access to confidential price-sensitive information that is not available to shareholders generally.

Persons with access to inside information through their employment, profession or duties need not have a contractual or fiduciary relationship with the company whose securities are traded.³⁴⁷ For instance, employees of an investment bank advising a potential bidder would be prohibited from acquiring shares in the intended target company. Those employees would have obtained the inside information by reason of their employment. It is less clear whether, say, an employee who has no right of access to inside information in his or her position but hears, by chance, of that information while at work would fall within the definition. However, that person may be a secondary insider.

This third group of primary insiders also appears to include persons who have no relationship with the issuer. Inside information can cover matters affecting, but derived from outside, companies (for instance, information that is likely to influence the market as a whole, such as changes in interest rates). Public officials and any other persons with access to this information through their employment, profession or duties would therefore fall within the category of primary insiders.

Secondary insiders. A secondary insider is “any person other than [a primary insider] who with full knowledge of the facts possesses inside information, the direct or indirect source of which could not be other than a [primary insider]”.³⁴⁸

The requirement that the person have “full knowledge of the facts” suggests that the person must be aware that the information is inside information, as defined under the EU Directive.

In addition, “the direct or indirect source” of the inside information must be a primary insider, that is, the secondary insider must be aware that there must have been a leak of information, the source of which was a primary insider. However, it is not necessary to identify the primary insider or to prove any relationship between the primary and secondary insider. The category of secondary insider could therefore include persons at the end of a long chain of information, provided it can be proved that the original information could not have come from anyone other than a primary insider.

Liabilities of insiders

Trading. The EU Directive requires Member States to prohibit primary insiders from “taking advantage of” inside information with full knowledge of the facts by acquiring or disposing of transferable securities for their own or another person’s account, either directly or indirectly.³⁴⁹

The Directive also requires Member States to impose similar trading prohibitions on secondary insiders.³⁵⁰

³⁴⁷ K Hopt, “Insider Regulation and Timely Disclosure”, FORUM Internationale no.21 (1996) at 7.

³⁴⁸ EU Directive, Article 4.

³⁴⁹ id, Article 2.

³⁵⁰ id, Article 4.

Disclosing inside information. The EU Directive provides that Member States should stipulate that primary insiders may not disclose inside information to any other person, unless the disclosure is made in the normal course of the exercise of the primary insider's employment, profession or duties³⁵¹ (thereby permitting the essential flow of information between market professionals and their advisers).

The Directive does not include a disclosure prohibition for secondary insiders. Therefore, persons other than primary insiders could lawfully pass on inside information down a communication chain. Any person at the end of that chain who trades would be liable for insider trading only if that person satisfied the definition of a secondary insider.

Procuring trading. The EU Directive provides that Member States should prohibit primary insiders from recommending or procuring another person to transact in marketable securities "on the basis of" inside information.³⁵² The recommendation need not mention the inside information; it suffices that the recommendation is made on the basis of the insider's knowledge of the inside information.

The EU model does not prohibit primary insiders from recommending or procuring another person to refrain from dealing in particular securities.

The Directive does not include a procuring prohibition for secondary insiders.

Entities other than natural persons

The EU Directive provides that, where the primary insider is a company or other type of legal person, the prohibition on trading shall apply to the natural persons who take part in the decision to carry out the transaction for the account of the legal person concerned.³⁵³ The EU Directive has no similar provision for trading by secondary insiders.

Use of inside information

The EU Directive provides that each member State shall prohibit insiders "from taking advantage of" inside information to acquire or dispose of securities.³⁵⁴ This implies that insiders must be shown to have used the information in some manner in reaching their trading decisions.

Modifying the Directive

The Directive is aimed at setting a minimum standard for insider trading laws in the Member States. Member States are free to adopt more stringent, or comprehensive, provisions than those laid down in the Directive, provided that the Directive provisions are applied generally.³⁵⁵ For instance, it is open to Member States to apply the disclosing and procuring prohibitions to secondary insiders.

³⁵¹ id, Article 3(a).

³⁵² id, Article 3(b).

³⁵³ id, Articles 2(2).

³⁵⁴ id, Article 2(1).

³⁵⁵ id, Article 6.

The United Kingdom and Germany, as well as other EU Member States, subsequently enacted legislation broadly following the EU model. However, as explained in Appendix 3 and Appendix 4, the UK and German provisions differ in significant respects.

Draft new EU Directive

The Commission of the European Communities in May 2001 released a proposal for a new Directive on *Insider Dealing and Market Manipulation (Market Abuse)* (the proposed Directive). If implemented, this Directive would substitute for the 1989 EU Insider Trading Directive.

Details of significant differences between the 1989 Directive and the proposed Directive, as well as cross-references to the relevant analysis in this Discussion Paper, are set out in Appendix 11.

Appendix 3

United Kingdom

The current UK criminal insider trading provisions under the Criminal Justice Act 1993 commenced in 1994.³⁵⁶ Additional civil provisions, introduced under the UK Financial Services and Markets Act 2000, apply from July 2001.

What is inside information

The UK legislation adopts a broad approach. There is no requirement for the company whose securities are traded to have generated the inside information. The information may come from any source, provided the information:

“relates to particular securities or to a particular issuer of securities or to particular issuers of securities and not to securities generally or to issuers of securities generally”.³⁵⁷

Furthermore:

“information shall be treated as relating to an issuer of securities which is a company not only where it is about the company but also where it may affect the company’s business prospects”.³⁵⁸

The purpose of the latter provision is to “catch as inside information, information which, while not relating directly to a company, would nevertheless be likely to have a significant effect on the price of its shares”.³⁵⁹

A possible restriction on what constitutes inside information arises for those primary insiders who “have access to” inside information by virtue of their employment, office or profession.³⁶⁰ One commentator has argued that, in consequence of this access requirement, the UK legislation does not cover self-generated inside information:

“The notion of having access would seem to require that the information in question is in existence independently of the person seeking to obtain it or access to it.”³⁶¹

³⁵⁶ Criminal Justice Act 1993 Part V Insider Trading (ss 52-64 and accompanying Schedules). In the UK, insider trading was first made a criminal offence under the Companies Act 1980 Part V. These provisions were amended and consolidated into the Company Securities (Insider Dealing) Act 1985. That legislation, in turn, was superseded by the 1993 legislation.

³⁵⁷ Criminal Justice Act 1993 s 56(1)(a).

³⁵⁸ *id.*, s 60(4).

³⁵⁹ Parliamentary Debates, House of Lords, 3 December 1992 at 1495.

³⁶⁰ Criminal Justice Act 1993 s 57(2)(a)(ii).

³⁶¹ B Rider in the CCH UK Financial Services Reporter (looseleaf) §42-200 at 43,502.

Level of precision of the inside information

The UK legislation states that inside information must be “specific or precise”.³⁶² Various commentators have pointed out that information may be specific, even though it has a vague and imprecise quality.³⁶³ Examples would be a person who has specific knowledge, but not the precise details, of an imminent rights issue, or a forthcoming statement of profit (or losses), by a company. Likewise, a person may have specific inside information that someone proposes to launch a takeover bid for a particular company, without having precise information about the details of that bid.

Who are insiders

The UK legislation applies only to “an individual”, meaning a natural person.³⁶⁴ Given this restriction, the UK legislation has no need for any “Chinese Walls” defence, which applies when inside information is held within a company or other entity.

The UK legislation defines “insider” to cover primary and secondary insiders.

Primary insiders. These are persons who have inside information:

- through being a director, employee or shareholder of an issuer of securities, or
- by having access to the information by virtue of their employment, office or profession.³⁶⁵ A person may obtain inside information and thereby be a primary insider “by virtue” of his or her employment, office or profession without necessarily having any direct professional, fiduciary or contractual connection with the company whose securities are traded. However, the ambit of this test appears unclear, and may have anomalous results.³⁶⁶

³⁶² Criminal Justice Act 1993 s 56(1)(b).

³⁶³ M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 97-98; B Rider in the CCH UK Financial Services Reporter (looseleaf) §42-140 at 43,403.

³⁶⁴ Criminal Justice Act 1993 s 52.

³⁶⁵ *id.*, s 57(2)(a).

³⁶⁶ B Rider in the CCH UK Financial Services Reporter (looseleaf) §42-200 at 43,501 comments that the category of persons having access to inside information by virtue of their employment, office or profession:

“will include professional advisers such as lawyers, merchant bankers, accountants, public relations specialists and the like. While it is not unreasonable to expect such persons to assume the responsibilities of insider status on a temporary basis, the wording of the section is wide enough to bring in many others performing rather more peripheral services to an issuer. Thus, it may be argued that office cleaners, temporary secretarial staff, postmen and couriers have access to information by virtue of their employment. While it is no doubt the case that an opportunity to acquire inside information may well have been presented through engaging in the activities of their employment, it is not clear whether it is appropriate to cast the net so widely. The better view under the previous legislation was that the information had to be obtained in the proper course and performance of the employment in question. An office cleaner rummaging through a waste paper bin could not be considered to be acting in the course of his or her employment.”

If the interpretation in the above extract is correct, persons may be able to avoid being primary insiders simply by acting outside the terms of their employment.

Secondary insiders. These are persons who hold inside information and who know that the “direct or indirect source” of that information is a primary insider.³⁶⁷ It is unclear whether the recipient must know the exact identity of the source and the circumstances under which the disclosure was made, or must simply be aware that the information has come from a primary source.³⁶⁸ It need not be shown either that a secondary insider sought the inside information or that the primary insider acted unlawfully in providing the information.

Another approach. The recently introduced additional civil remedy for market abuse, including insider trading, applies to any person whose behaviour is based on inside information. There is no distinction between primary and secondary insiders, or any requirement that the person be linked directly or indirectly to the company whose securities are traded. However, there are other restrictions on who is an insider under the civil legislation (see **Regulator’s remedies**, post).³⁶⁹

Liabilities of insiders

Primary and secondary insiders under the UK law are subject to the same trading, disclosing and procuring offences. They also have the same defences.

Trading

Primary and secondary insiders are prohibited from acquiring or disposing of securities, either as principals or agents for someone else, subject to various statutory defences.³⁷⁰

These insiders are not guilty of insider trading if they show that they:

- did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the inside information, or
- believed at that time, on reasonable grounds, that the information had been or would be sufficiently disclosed to avoid prejudicing any participant in the dealings who did not have the information, or
- would have done what they did even if they had not had the information.³⁷¹

Conversely, a broad interpretation of the employment etc connection could give rise to apparently artificial distinctions in determining who is an insider. For instance, take the situation where two directors of a company are discussing inside information in a restaurant. Their discussion is overheard by a waiter employed by the restaurant, a diner having a social lunch and a diner having a business lunch. Arguably, the waiter would be a primary insider as that person had access to the information by virtue of his employment. By contrast, the social diner would not be a primary insider. The business lunch diner might be a primary insider, depending on whether that person could be said to have access to the information by virtue of the person’s employment or profession.

³⁶⁷ Criminal Justice Act 1993 s 57(1), (2)(b).

³⁶⁸ Wotherspoon, “Insider Dealing – The New Law: Part V of the Criminal Justice Act of 1993” (1994) 57 *Modern Law Review* 419 at 427.

³⁶⁹ Financial Services and Markets Act 2000 s 118.

³⁷⁰ Criminal Justice Act 1993 ss 52(1), 55(1)(a), (2), (3).

³⁷¹ *id.*, s 53(1).

The trading prohibition only applies to dealing. A primary or secondary insider may lawfully refrain from trading (or cancel orders to trade) on the basis of the inside information.

Disclosing inside information

Subject to various statutory defences, primary and secondary insiders are prohibited from disclosing inside information to another person.³⁷² The defences are:

- the disclosure took place in the proper performance of the functions of the primary or secondary insider's employment, office or profession³⁷³
- the insider can show that he or she did not expect the recipient (or any other person) to trade because of the disclosure.³⁷⁴ This defence would, for instance, protect insiders who confide information to another person, not as part of the proper performance of their official functions, but for reasons unrelated to trading in those securities
- the insider can show that, although he or she expected that the recipient would trade, the insider did not expect that any such trading would result in a profit, or avoidance of a loss, attributable to the inside information.³⁷⁵

Procuring transactions

Primary and secondary insiders are liable for procuring another person to acquire or dispose of affected securities.³⁷⁶ They are also liable for encouraging another person to deal in affected securities, where they know, or have "reasonable cause to believe", that the other person will so deal (though it is not essential that dealing actually take place).³⁷⁷ It is irrelevant whether or not the person encouraged realises that the person encouraging is a primary or secondary insider or that inside information is being used as a basis for the recommendation. The offence focuses solely on the conduct and state of mind of the primary or secondary insider. However, primary and secondary insiders may lawfully procure other persons not to trade.

Primary or secondary insiders have three defences to procuring or encouraging another person to deal in affected securities, by showing that they:

- did not expect that any dealing in these securities would result in a profit, or avoidance of a loss, attributable to the fact that the information was inside information, or
- believed at that time, on reasonable grounds, that the information had been or would be sufficiently disclosed to avoid prejudicing any participant in the dealings who did not have the information, or

³⁷² id, s 52(2)(b).

³⁷³ id, s 52(2)(b).

³⁷⁴ id, s 53(3)(a).

³⁷⁵ id, s 53(3)(b).

³⁷⁶ id, s 52(1), as applied to procuring by virtue of s 55(1)(b), (4) and (5).

³⁷⁷ id, s 52(2)(a).

- would have done what they did even if they had not had the inside information.³⁷⁸

Research and analysis

The UK statute provides that information may be treated as having been made public (and therefore not being inside information) even though it can be acquired only by persons exercising diligence or expertise or by observation.³⁷⁹ Unlike the German law, the UK legislation does not expressly require that the diligence or expertise must be exercised only on publicly available information, though it may be illogical to characterise information gleaned by a researcher from otherwise totally confidential sources as having been made public.

The UK provisions also provide a defence to persons who can show that they would have acted in the same manner even without the inside information.³⁸⁰ This defence could apply to a person who, on the basis of research and analysis of publicly available information, decides to buy or sell certain securities, and subsequently, but prior to trading, obtains inside information that supports that previously reached decision.

On-market and off-market application of insider trading prohibition

The UK prohibition on trading or procuring only applies to acquisitions or disposals that occur on a designated regulated domestic or foreign market or where the person trading in the price-affected securities has relied on a professional intermediary, or was himself or herself acting as a professional intermediary.³⁸¹ The purpose of these provisions is to exclude from the scope of criminal liability a truly private deal executed off-market and without the involvement of a market professional.

Use of inside information

The UK legislation does not require the prosecution to show that an accused used the inside information. Instead, insiders have a defence if they establish that they did not use the inside information in their trading:

“An individual is not guilty of insider dealing by virtue of dealing in securities if he shows that he would have done what he did even if he had not had the information”³⁸².

Regulator’s remedies

The United Kingdom has developed an administrative regulatory regime for insider trading in addition to the existing criminal jurisdiction.

³⁷⁸ id, ss 53(1) (procuring), 53(2) (encouraging).

³⁷⁹ id, s 58(3)(a), (c).

³⁸⁰ id, s 53(1)(c).

³⁸¹ id, ss 52(3), 54(1). Professional intermediaries are defined in s 59. The UK Treasury designates the regulated markets by published Order: the Insider Dealing (Securities and Regulated Markets) Order 1994.

³⁸² Criminal Justice Act 1993 s 53(1)(c).

The UK Financial Services and Markets Act 2000 defines various categories of market abuse, including misuse of information through insider trading.³⁸³ Under that Act, the UK Financial Services Authority (FSA) has issued a Code of Market Conduct setting out what behaviour the FSA believes amounts to misuse of information and other forms of market abuse.³⁸⁴ This Code applies to all markets, including commodity, derivatives and financial futures markets and to all participants in those markets.

The FSA Code of Market Conduct deals with any person who engages in market abuse through insider trading or who requires or encourages another person to do so (for instance, by causing, procuring or advising that other person). The following four key prerequisites for liability are designed to focus on market behaviour and expectations.

- *The person must possess information that is not generally available to the market at large.* Information is treated as generally available if it can be obtained by such means as observation (without infringing rights of privacy, property or confidentiality), through access to records that are open to inspection by the public (including through the Internet), or by research or analysis conducted by or on behalf of users of a market. Information will also be regarded as generally available even if only published overseas or available on payment of a fee.³⁸⁵
- *The information would be likely to be regarded by a regular user in the market as relevant when deciding the terms on which transactions in investments of the kind in question should be effected.* A regular user in relation to a particular market is defined as “a reasonable person who regularly deals on that market in investments of the kind in question”.³⁸⁶ The question of whether certain information is relevant will depend on various factors, including how specific, precise, current and reliable it is. In this context, information can include matters relating to possible future developments, depending on the level of certainty of their occurrence and their significance if they were to occur.³⁸⁷
- *The information must relate to matters which 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.* Such information is either information that has to be disclosed to the market pursuant to any legal or regulatory requirement (disclosable information) or information that is usually the subject of a public announcement, although not subject to any formal disclosure requirement (announceable information).³⁸⁸

³⁸³ Financial Services and Markets Act 2000 s 118.

³⁸⁴ id, s 119, FSA Code of Market Conduct April 2001.

³⁸⁵ Financial Services and Markets Act 2000 s 118(7), FSA Code of Market Conduct April 2001, Annex B, paras 1.4.5 ff.

³⁸⁶ Financial Services and Markets Act 2000 s 118(10). The regular user test is further analysed in the FSA Code of Market Conduct April 2001 paras 5.1 ff.

³⁸⁷ FSA Code of Market Conduct April 2001, Annex B paras 1.4.9 ff.

³⁸⁸ id, paras 1.4.12 ff.

This has various implications. There is no precise test for determining when information concerning future developments becomes inside information. Also, the extent to which a regular user may reasonably expect to have access to information on an equal basis is different in different markets. For instance, regular users of commodities markets would not expect to receive the same amount of information on the same basis as regular users of equity markets.³⁸⁹ Furthermore, information concerning a person's own or any other person's intention to deal or not to deal does not constitute inside information, given that other users of the market would not expect to have equal access to such information.³⁹⁰ In consequence, behaviour such as scalping, frontrunning or piggy backing³⁹¹ may not be caught under these provisions, as the market would not expect information about clients to be made public.

The consequence for adopting this approach in Australia would be to exclude information that is exempt from continuous disclosure.

- *The person's behaviour must be based on the information, and not be required for other reasons.* It need not be shown that the person engaging in the behaviour intended to abuse the market. However, the information held by that person must have a material influence on his or her decision to engage in the transaction. The information must be one of the reasons, but need not be the only reason, for trading. By contrast, a dealing will not constitute insider trading if the person has made a firm decision to deal before the relevant information was in his or her possession and the terms on which that person proposed to enter into the transaction did not alter after the receipt of the information.³⁹²

A dealing will not amount to insider trading if the person was required to deal in order to comply with a legal (including contractual) or regulatory obligation in circumstances where the obligation existed before the relevant

³⁸⁹ id, paras 1.2.7 & 1.4.17 indicate that the disclosure standards vary between markets. For instance, the disclosure standards expected in equity markets differ from those expected in commodities markets:

“The Code makes clear that where relevant information is required to be disclosed to market A, and it is also relevant to market B in which there is no disclosure obligation, dealing or arranging deals based on the information in relation to investments traded on market B will not amount to market abuse. Any dealing or arranging deals based on the information in relation to market A, before it is disclosed, will amount to market abuse.” (para 6.10)

³⁹⁰ UK Financial Services Authority Consultation Paper 59, *Market Abuse: A Draft Code of Market Conduct* (July 2000), paras 6.48-6.54. The Paper gives the following example. Firm A learns that Firm B is about to execute a large portfolio trade on behalf of Fund Manager C. Firm A has sufficient detail about the identity of the stocks to position itself to benefit from the market impact of the trade. Firm A would be free to use that information, since it concerns another person's intention to trade.

³⁹¹ Scalping is advisers trading in advance of conveying their trading recommendations to clients. Frontrunning is advisers transacting on their own behalf before implementing their clients' instructions. Piggy backing is advisers transacting with knowledge of a client's trading strategy and in advance of receiving specific instructions based on that strategy.

³⁹² FSA Code of Market Conduct April 2001, Annex B, paras 1.4.20 ff.

information was in that person's possession. There is also an exclusion for transactions prior to takeover bids.³⁹³

However, unlike criminal liability in the UK, it is no defence that the person did not expect the dealing to result in a profit attributable to the price-sensitive information. This defence is not relevant in the context of market abuse, where the mischief being prevented is abuse of a market, rather than personal gain.³⁹⁴

A person who passes inside information to another may be liable for encouraging the recipient to trade, unless the disclosure is made for a legitimate purpose. In some instances, the disclosure must be accompanied by a statement when or before the information is passed that the information is given in confidence and that the recipient should not act on that information until it has been made generally available.³⁹⁵

Where the FSA considers that the above four elements of market abuse through insider trading have taken place, it may seek various court remedies, including the imposition of financial penalties.³⁹⁶ Any payment by a defendant must be made to the FSA, for distribution to affected persons.³⁹⁷

Alternatively, the FSA may itself impose administrative financial penalties for breach of the Code of Market Conduct or rely on public censure by publishing a statement to the effect that a person has engaged in market abuse.³⁹⁸ The perpetrator can have the matter referred to the Financial Services and Markets Tribunal and may appeal to a court on points of law.³⁹⁹ There is no requirement to prove that the person engaging in the insider trading intended to abuse the market. However, the FSA may not impose a penalty if there are reasonable grounds for it to be satisfied that the person believed on reasonable grounds that his or her behaviour did not amount to market abuse, or requiring or encouraging another person to engage in market abuse, or the person has

³⁹³ *ibid.*

³⁹⁴ UK Financial Services Authority Consultation Paper 59, *Market Abuse: A Draft Code of Market Conduct* (July 2000), para 6.55. Contrast the UK Criminal Justice Act 1993 s 53, which provides a defence if the defendant can show "that he did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the fact that the information in question was price-sensitive information in relation to the securities".

³⁹⁵ FSA Code of Market Conduct April 2001, Annex B, Part 1.8 *Requiring or encouraging*.

³⁹⁶ Financial Services and Markets Act 2000 ss 129, 381, 383.

³⁹⁷ *id.*, s 383.

³⁹⁸ *id.*, s 123.

³⁹⁹ *id.*, ss 132-137.

taken all reasonable precautions and exercised all due diligence to avoid engaging in market abuse.⁴⁰⁰

This administrative regulatory regime is independent of the existing UK criminal offence of insider dealing, which continues to apply.

⁴⁰⁰ id, s 123(2).

Appendix 4

Germany

Insider trading (Insidergeschäften) was made a criminal offence in Germany under the Securities Trading Act (Wertpapierhandelsgesetz (WpHG)) in 1994.⁴⁰¹ There are no statutory civil insider trading provisions.

What is inside information (Insidertatsache)

The WpHG adopts a broad approach. It refers to any non-public price-sensitive information relating to one or more issuers of insider securities, or to insider securities, but without any requirement that those issuers generate the information.⁴⁰² For instance, inside information has been held to include a broker's knowledge of a client's actual or anticipated trading instructions, thereby going beyond any information generated by the company whose securities are traded.⁴⁰³

The WpHG does not appear to have a restriction on self-generated inside information, as may be the case in the UK. The WpHG has no equivalent of the UK requirement that the primary insider "have access to" inside information. It suffices that the person has knowledge of inside information by virtue of the person's profession, employment or duties.⁴⁰⁴ A recent case on scalping (trading in advance of publishing one's own recommendations) held that self-generated information is covered.⁴⁰⁵

⁴⁰¹ WpHG §§12-14, 38. From 1970 to 1994, insider trading was regulated under guidelines adopted by German stock exchanges and agreed to by many of Germany's major public companies. A useful analysis of the background to the implementation of the WpHG is found in DJ Standen, "Insider trading reforms sweep across Germany: bracing for the cold winds of change" (1995) 36 *Harvard International Law Journal* 186.

⁴⁰² WpHG §13(1) defines inside information (Insidertatsache) as any information which has not been made public relating to one or more issuers of insider securities, or to insider securities (Insiderpapiere), which, if it were made public, would be likely to have a significant effect on the price of those securities. Insider securities are broadly defined in §12.

⁴⁰³ The Bundesaufsichtsamt für den Wertpapierhandel (BAWe) [Federal Supervisory Office for Securities Trading] *1999 Annual Report* (Jahresbericht) refers (at 21) to a number of instances where action against frontrunning (that is, brokers trading in advance of implementing their clients' materially price-sensitive trading instructions) was taken under the insider trading provisions.

⁴⁰⁴ WpHG §13(1)3.

⁴⁰⁵ The BAWe *1999 Annual Report* at 25 refers to a November 1999 decision of the regional Court of Frankfurt am Main, which ruled that a business journalist who purchased securities before the publication of his price-sensitive recommendations, with the aim of benefiting from the resulting price gain, was liable for insider trading. The Court ruled that mental processes such as the intention to release a recommendation can represent inside information. Under the WpHG, the business journalist would be prohibited from either purchasing affected securities before the publication of his recommendation, or informing third parties in advance about what securities he would recommend.

Level of precision of the inside information

The WpHG has no precision requirement. Its definition of inside information follows the language of the EU definition, except for omitting the requirement that the information be “of a precise nature”.⁴⁰⁶

Who are insiders

The WpHG covers primary and secondary insiders, the latter category being significantly broader than under the UK legislation.

Primary insiders. These are persons who have knowledge of inside information by virtue of:

- their membership of the managing organs of the company whose securities are traded or a connected undertaking,⁴⁰⁷ or
- their holding equity in either entity,⁴⁰⁸ or
- their employment, profession or duties (whether or not these are to the company whose securities are traded).⁴⁰⁹ For instance, lawyers, accountants or brokers who learn inside information in the scope of their profession are covered. Thus, a broker who trades with knowledge, and in advance, of his or her client’s instructions (frontrunning) has been treated as a primary insider, as the broker had access to that inside information by virtue of his or her employment, profession or duties.⁴¹⁰ Less certain is whether corporate employees etc whose activities do not involve the handling of inside information, or who obtain information merely by chance, are covered.⁴¹¹

There must be a causal link between the position held by the insider and that person’s access to inside information.⁴¹² However, in the absence of this causal link, a person with knowledge of inside information may still fall within the much broader category of secondary insiders.

Secondary insiders. The WpHG defines secondary insiders very broadly by, in effect, adopting an “information connection” approach. These insiders are any persons who are not primary insiders but nevertheless have knowledge of inside information.⁴¹³

⁴⁰⁶ WpHG §13(1).

⁴⁰⁷ WpHG §13(1)1. The concept of “a connected undertaking” (“ein verbundenes Unternehmen”) is not defined in the WpHG, but is a well known term in German corporate group law, being defined under §15 of the German law on public companies (Aktiengesetz).

⁴⁰⁸ WpHG §13(1)2.

⁴⁰⁹ WpHG §13(1)3.

⁴¹⁰ The BAWe *Annual Report 1999* refers (at 21) to a number of instances where action against frontrunning was taken under the insider trading provisions.

⁴¹¹ C Estevan-Quesada, “The Implementation of the European Insider Dealing Directive” (1999) 10 *European Business Law Review* 492 at 497.

⁴¹² C Estevan-Quesada, *ibid*, has referred to the following test to determine whether persons fall within the category of primary insider by virtue of their shareholding in the company or a connected undertaking: would they have obtained inside information if they had not been shareholders of the issuer or of a connected enterprise?

⁴¹³ WpHG §14(2).

How that information came into their possession is irrelevant. A secondary insider may have obtained the inside information in any way, including from a primary insider, another secondary insider, by chance, by theft or by espionage. There is no equivalent of the EU model or UK requirement that the “direct or indirect source” of the inside information be a primary insider. However, under German law, the recipient must know, rather than merely suspect, that the information he or she receives is inside information.

Liabilities of insiders

The WpHG is based on the EU model, but does not have the range of statutory defences found in the UK Act.

Trading

Primary and secondary insiders are prohibited from taking advantage of their knowledge to buy or sell securities on their own or someone else’s account.⁴¹⁴

There are no statutory defences to trading equivalent to those found in the UK legislation. However, insiders may lawfully refrain from trading (or cancel orders to trade) on the basis of inside information.

Disclosing inside information

Primary insiders. Primary insiders are prohibited from disclosing or making available inside information to a third party without authority to do so.⁴¹⁵ It is irrelevant whether the primary insider intended or suspected that the recipient would trade in the relevant securities, or whether the recipient did in fact so trade.

Other than where a disclosure is authorised, there are no statutory defences to disclosing. This contrasts with the range of statutory defences in the UK legislation.

Secondary insiders. Unlike the UK law, the WpHG does not expressly prohibit secondary insiders from passing on inside information. This omission was described in the German Upper House (Bundesrat), during debate on the WpHG, as a “significant loophole” in the legislation, though the provisions were not amended.

On one view, no statutory provision is necessary. Any secondary insider who without authority discloses inside information to a third person may be liable for soliciting or aiding and abetting if that third person subsequently trades (given that the informed third person has become a secondary insider and is therefore prohibited from trading).⁴¹⁶ The contrary view is that the WpHG intentionally omitted any liability for secondary insiders who disclose inside information, and the general aiding and abetting provisions should not be applied in this context. In any event, the aiding and abetting provisions would probably only cover the secondary insider who disclosed

⁴¹⁴ WpHG §14(1)1, 14(2).

⁴¹⁵ WpHG §14(1)2.

⁴¹⁶ German Criminal Code (Strafgesetzbuch) §§26, 27.

information to the person who traded, not any intermediate persons who pass on inside information in a communication chain.⁴¹⁷

Procuring transactions

Primary insiders. Primary insiders are prohibited from recommending, on the basis of their inside knowledge, that a third party acquire or dispose of insider securities.⁴¹⁸ The WpHG does not require that the inside information be disclosed to the third party. Likewise, it has no equivalent of the UK statutory requirement that the primary insider know or have reasonable cause to believe that the third party will trade. The mere recommendation is enough. Also, there is no equivalent of the UK statutory defences to procuring. However, there is no prohibition on primary insiders procuring third parties not to trade.

Secondary insiders. Unlike the UK law, the WpHG does not expressly prohibit secondary insiders from procuring. On one view, a statutory provision may be unnecessary. Any secondary insider who procures a third person to trade by disclosing the inside information may be liable for soliciting or aiding and abetting any breach by that third person (given that the informed third person has become a secondary insider and therefore cannot trade). The contrary view is that the omission of any specific liability on secondary insiders for procuring overrides any general aiding and abetting provisions.⁴¹⁹

Research and analysis

The WpHG provides an exemption for research and analysis only if they are based entirely on publicly known information. The research and analysis can lawfully be used for trading, even if they could considerably affect the price of the securities.⁴²⁰

On-market and off-market application of insider trading prohibition

The WpHG applies to securities that are capable of being traded (whether or not actually traded) on a designated regulated domestic or foreign market.⁴²¹

Use of inside information

The WpHG provides that insiders or persons who receive inside information from an insider are forbidden from using or taking advantage of their knowledge to trade.⁴²² Presumably, the prosecution must prove that they knowingly used the information.

⁴¹⁷ C Estevan-Quesada, “The Implementation of the European Insider Dealing Directive” (1999) 10 *European Business Law Review* 492 at 498.

⁴¹⁸ WpHG §14(1)3.

⁴¹⁹ C Estevan-Quesada, “The Implementation of the European Insider Dealing Directive” (1999) 10 *European Business Law Review* 492 at 498.

⁴²⁰ WpHG §13(2).

⁴²¹ WpHG §12(1) defines insider securities (Insiderpapiere) as any securities that are admitted to official trading on a German stock exchange or free market (Freiverkehr) or are admitted to trading on various designated foreign markets. Securities are deemed to be admitted to trading on an organized market, or to be traded on a free market, once the application for such trading has been submitted or publicly announced.

⁴²² WpHG §14(1)1, 14(2) – “unter Ausnutzung seiner/dieser Kenntnis”.

Regulator's remedies

The Federal Supervisory Office for Securities Trading (Bundesaufsichtsamt für den Wertpapierhandel: BAWe) has responsibility for ensuring the proper functioning of German securities and derivatives markets, including combatting and preventing insider trading. The BAWe has statutory powers to investigate possible instances of insider trading. It may report matters to the public prosecutor's office,⁴²³ which may bring criminal proceedings⁴²⁴ or discontinue these proceedings where the defendant has agreed to pay an appropriate fine or civil penalty.⁴²⁵

No civil remedies

The WpHG does not provide for any civil claims by counterparties, contemporaneous traders or the company whose securities are traded.

⁴²³ WpHG §18.

⁴²⁴ WpHG §38.

⁴²⁵ Strafprozessordnung (Code of Criminal Procedure) s 153a.

Appendix 5

South Africa

The South African Insider Trading Act 1998 is largely modelled on the UK Criminal Justice Act 1993.⁴²⁶ It contains civil, as well as criminal, provisions.

What is inside information

“Inside information” means specific or precise information that has not been made public and that:

- is obtained or learned as an insider; and
- if it were made public would be likely to have a material effect on the price or value of any security of financial instrument.⁴²⁷

Who are insiders

The South African legislation applies only to “an individual”, meaning a natural person.⁴²⁸ However, the legislation applies, whether individuals act on their own behalf or on behalf of some other natural person or entity.⁴²⁹ Given this restriction, the legislation has no need for any “Chinese Walls” defence, which applies when inside information is held within a company or an entity.

The South African legislation also adopts the UK approach of defining “insider” to cover both primary and secondary insiders.

Primary insiders. These are persons who have inside information through:

- being a director, employee or shareholder of an issuer of securities or financial instruments to which the inside information relates; or
- having access to such information by virtue of their employment, office or profession.⁴³⁰

⁴²⁶ Previously, the South African Companies Act contained criminal sanctions for insider trading. However, no criminal prosecutions had been commenced under that legislation. The current legislation was based on the *Final Report by the King Task Group into Insider Trading Legislation* (October 1997) (the King Report). This legislation reflects the policy of strengthening the insider trading provisions “to change the perception held [in the late 1990s], both locally and internationally, that there is a high incidence of insider trading in the South African securities markets”: Financial Services Board, South Africa, *Report on the activities of the Insider Trading Directorate*.

⁴²⁷ South African Insider Trading Act 1998 s 1(vii).

⁴²⁸ id, s 1(viii), s 2.

⁴²⁹ id, s 2(1)(a) states that prohibited dealing includes dealing “directly or indirectly for his or her own account or for any other person”. Person in this context is not confined to natural persons.

⁴³⁰ id, s 1(viii)(a).

Secondary insiders. These are persons who have inside information and who know that the direct or indirect source of that information is a primary insider.⁴³¹

Liabilities of insiders

As in the UK legislation, primary and secondary insiders are subject to the same trading, disclosing and procuring offences. However, the elements of those offences are not identical to those in the UK legislation, and there are fewer statutory defences.

Trading

A primary or secondary insider is prohibited from dealing “directly or indirectly, for his or her own account or for any other person, in the securities or financial instruments to which [the inside] information relates or which are likely to be affected by it”.⁴³²

An insider has the statutory defence that he or she “would have acted in the same manner, even without the inside information”.⁴³³ The Act omits the two other statutory defences found in the UK legislation.⁴³⁴

Disclosing inside information

It is an offence for a primary or secondary insider who knows that he or she has inside information to disclose that information to someone else.⁴³⁵ Liability does not depend on the insider having received any financial or other reward for this disclosure.

An insider has a defence by establishing on the balance of probabilities that:

- the disclosure was in the course of the insider’s employment, office or profession *and the insider, at the same time, disclosed that the information was inside information* (thereby putting the recipient on notice) (the additional italicised requirement is not found in the UK legislation),⁴³⁶ or
- the insider believed on reasonable grounds that no person would deal in the securities as a result of the disclosure.⁴³⁷

There is no equivalent of the UK defence that an insider can show that, although he or she expected that the recipient would trade, the insider did not expect that any such

⁴³¹ id, s 1(viii)(b).

⁴³² id, s 2(1)(a).

⁴³³ id, s 4(1)(b).

⁴³⁴ The two UK statutory defences that are omitted from the South African legislation are if insiders show that they:

- did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the inside information
- believed on reasonable grounds that the information had been disclosed widely enough to avoid any participant in the dealing being prejudiced by not having the information.

⁴³⁵ South African Insider Trading Act 1998 s 2(2).

⁴³⁶ id, s 4(2)(b).

⁴³⁷ id, s 4(2)(a).

trading would result in a profit, or avoidance of a loss, attributable to the inside information.

Procuring transactions

Primary and secondary insiders are liable if they encourage or cause another person to deal in affected securities.⁴³⁸ There is no requirement that they receive any financial or other reward from this procurement.

The South African legislation contains no equivalent of the UK requirement that the primary or secondary insider knows or has reasonable cause to believe that the other person will deal in the affected securities.

Insiders are also liable if they “discourage or stop” another person from dealing in affected securities.⁴³⁹ This prohibition on discouraging dealing is not found in any other jurisdictions reviewed in this Discussion Paper, including Australia, and in this regard sets South Africa apart from all these other jurisdictions.

As with the UK legislation, it is a defence if the insider proves on the balance of probabilities that he or she “would have acted in the same manner even without the inside information”.⁴⁴⁰ However, there is no equivalent of the two additional UK statutory defences.⁴⁴¹

Research and analysis

The South African statute, following the UK model, provides that information may be treated as having been made public (and therefore not being inside information) even though it can be acquired only by persons exercising diligence or expertise or by observation.⁴⁴² In contrast to the German law, the South African legislation does not expressly require that the diligence or expertise must be exercised only on publicly available information, though it may be illogical to characterise information gleaned by a researcher from otherwise totally confidential sources as having been made public.

The South African provisions also provide a defence to persons who can show that they would have acted in the same manner even without the inside information.⁴⁴³ This defence could apply to a person who, on the basis of research and analysis of publicly available information, decides to buy or sell certain securities, and subsequently, but prior to trading, obtains inside information that supports that previously reached decision.

⁴³⁸ id, s 2(1)(b).

⁴³⁹ Ibid.

⁴⁴⁰ South African Insider Trading Act 1998 s 4(1)(b).

⁴⁴¹ The two UK statutory defences that are omitted from the South African legislation are that:

- the insider did not expect that any dealing in these securities would result in a profit, or avoidance of a loss, attributable to the fact that the information was inside information
- the insider believed at that time, on reasonable grounds, that the information had been or would be sufficiently disclosed to avoid prejudicing any participant in the dealings who did not have the information.

⁴⁴² South African Insider Trading Act 1998 s 3(2)(a).

⁴⁴³ id, s 4(1)(b).

On-market and off-market application of insider trading prohibition

The South African legislation covers all listed securities and financial instruments, whether traded on-exchange or over-the-counter (OTC).⁴⁴⁴ The King Task Group Final Report (1997) took the view that it was unnecessary to include unlisted securities in the legislation, because common law civil remedies were available.⁴⁴⁵

Use of inside information

The South African legislation follows the UK model. It provides a defence of non-use, namely where the insider proves on the balance of probabilities that he or she would have acted in the same manner even without the inside information.⁴⁴⁶

Intermediary acting on clients' instructions

The South African legislation provides that an intermediary trading for a client is not guilty of an offence if the intermediary proves on a balance of probabilities that he or she:

“was acting on specific instructions from a client, *save where the inside information was disclosed to him or her by that client*”.⁴⁴⁷ [emphasis added]

This makes it clear that an intermediary cannot lawfully transact in particular securities on the instructions of a client who has given the intermediary inside information regarding those securities.

Regulator's remedies

In addition to criminal proceedings, the Financial Services Board may institute civil proceedings on behalf of all eligible claimants (see post) for a breach of the insider trading law. The Board may claim for:

- any amount of profit gained or loss avoided in consequence of the breach, and
- an additional penalty, for compensatory or punitive purposes, of an amount determined by the court up to three times the profit gained or loss avoided.

This renders persons in breach of the legislation potentially liable for up to four times the amount of any profit gained or loss avoided on illegal transactions. The amount of the profit gained or loss avoided shall be determined at the discretion of the court, which must have regard to factors such as the consideration for the dealing and the time between the relevant dealing and the publication of the inside information.⁴⁴⁸

⁴⁴⁴ id, s 1 definitions of “financial instrument”, “regulated market” and “securities”, R Jooste, ‘The Regulation of Insider Trading in South Africa – Another Attempt’ (2000) 117 *South African Law Journal* 284 at 287.

⁴⁴⁵ King Report at §3.3.3.

⁴⁴⁶ South African Insider Trading Act 1998 s 4(1)(b).

⁴⁴⁷ id, s 4(1)(a).

⁴⁴⁸ id, s 6.

Funds recovered shall be first applied to cover all expenses reasonably incurred in bringing the civil proceedings, with remaining funds being distributed to eligible claimants.⁴⁴⁹ In any later criminal proceedings, the court shall take into account any award or penalty previously made in civil proceedings arising from the same cause.⁴⁵⁰

Eligible claimants

Who are eligible claimants depends on the time lapse between the insider dealing and the publication of the inside information. Eligible claimants are:

- where the inside information was made public within a week of the insider having traded, any persons who dealt within that week in the same securities or financial instruments on the opposite side of the market to the insider
- if the time lapse was more than a week, any persons who dealt in the same securities or financial instruments on the opposite side of the market to the insider on the same day that the insider traded.⁴⁵¹

There is no requirement that eligible claimants prove actual loss. Instead, the funds recovered are distributed to eligible claimants, according to the volume of their trading in the affected securities. Where the funds recovered from the insider under the civil action are less than the amount claimed by all affected persons, these funds are to be prorated.⁴⁵²

⁴⁴⁹ id, s 6(5).

⁴⁵⁰ id, s 7.

⁴⁵¹ id, s 6(6).

⁴⁵² id, s 6(7).

Appendix 6

United States

The United States insider trading laws have developed over a number of decades through a series of judicial interpretations of a general anti-fraud statute.⁴⁵³ This primarily non-legislative approach has resulted in the US laws developing in a piecemeal manner, given that the courts only deal with specific matters as they arise. This contrasts with attempts at more comprehensive regulation in jurisdictions having specific insider trading legislation.

What is inside information

The US courts have adopted the broad approach. Inside information can include, for instance, knowledge that the Government is about to take anti-trust enforcement action against a particular issuer (thereby depressing the price of its securities), or knowledge that a key investment analyst is about to change a public recommendation regarding the issuer.⁴⁵⁴

Level of precision of the inside information

US courts have ruled that inside information is not limited to verifiable facts. It includes any information that might affect the value of the securities in question, such as plans or proposals or projections and estimates regarding an entity's earnings and liabilities.⁴⁵⁵ Inside information can also include information that contradicts or calls

⁴⁵³ Rule 10b-5 was promulgated under s 10(b) of the Securities Exchange Act 1934. Section 10(b) contains the Exchange Act's general anti-fraud provisions. Rule 10b-5 does not explicitly mention insider trading, but is nevertheless the principal basis for US insider trading law. Rule 10b-5 states that:

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange:

- (1) To employ any device, scheme or artifice to defraud,
- (2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they were made, not misleading, or
- (3) To engage in any act, practise, or course of business which operates or would operate as a fraud or deceit on any person,

in connection with the purchase or sale of any security”.

⁴⁵⁴ *SEC v Seibald* Federal Securities Law Reporter (CCH) [1997 Transfer Binder] §99,586.

⁴⁵⁵ Under US law, material non-public information is any information the disclosure of which would be likely to result in a substantial change in the price of a security. In practice, an issue is how to deal with information that suggests only a possibility of a price movement in a stock, rather than a substantial certainty (for instance, pre-merger or pre-takeover bid discussions or feasibility studies). The US courts have adopted a “probability magnitude” test, which assesses the likelihood that an event will occur against its magnitude if it should occur. Where the magnitude is higher, the likelihood can be lower: see further D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §5.02[1] at 5-6 ff.

into question prior assumptions about a company that were held by investors generally.⁴⁵⁶

A course of conduct can also constitute inside information. For instance, in one case, a broker observed that one of his firm's clients consistently bought shares in advance of their nomination as "stock of the week" in a market influential publication. The broker set up a programme of parallel trading of whatever shares the client gave instructions to purchase. The broker's own trading was deemed to amount to insider trading.⁴⁵⁷

Inside information can comprise a combination of discrete pieces of information, none of which, in isolation, is precise or conclusive. The courts have adopted this "mosaic" approach towards determining what is inside information.⁴⁵⁸

Liability for disclosure of inside information does not require that the information disclosed be precise. For instance, it would suffice if a primary insider in a particular company simply indicated to a recipient that events were occurring that would result in an increase or decrease in the market price of that company's securities. The recipient could also be liable for trading, where, notwithstanding the lack of specifics, the recommendation itself and the recipient's awareness of its source (and the credibility of that source) placed the recipient at a considerable advantage vis-à-vis the investing public generally.⁴⁵⁹

Who are insiders

⁴⁵⁶ In *Lilly v State Teachers Retirement Board* 608 F.2d 55 (1979), the Court pointed out that: "The reasonable investor has an interest in knowing not only information which will, with reasonable certainty, affect the price of the stock he contemplates buying or selling. He also has an interest in obtaining information which renders it impossible to assess the value of his investment with reasonable certainty and turns an otherwise reasonable investment into a speculative one" (at 60). Another example of inside information that contradicts public assumptions or perceptions would be information that a company has engaged in illegal activity, thereby artificially enhancing the price of its securities: *SEC v Patel* Federal Securities Law Reporter (CCH) [1994-95 Transfer Binder] §98,340.

⁴⁵⁷ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §11.04[1] at 11-22.

⁴⁵⁸ In *State Teachers Retirement Board v Fluor Corp* 566 F.Supp. 945 (1983), the Court noted that: "A skilled analyst with knowledge of the company and the industry may piece together seemingly inconsequential data, together with public information into a mosaic that reveals material non-public information. ... Although the information may be seemingly insignificant, if it completes the mosaic or the matrix and it is non-public, it may be material" (at 949).

In *SEC v Falbo* 14 F.Supp. 2d 508 (1998), the defendant was married to an administrative officer of company A, which was in the process of secretly formulating a takeover bid for company B. At a social function, the defendant heard some employees of company A talking about how interesting it was to be working on "an acquisition". Then, using his position as an electrician in the offices of company A, the defendant eavesdropped in an effort to ascertain the target. Finally, he overheard an officer of company A on the phone discussing company C, which he ascertained through his own research was a subsidiary of company B. He also learned of the travel plans of various officers of company A to the city where company B had its headquarters, as well as other small but helpful bits of information in conversations with his wife (who was unaware that company B was a takeover target). Gradually he became convinced that company B was the stock to buy. The Court held that he was in possession of inside information.

⁴⁵⁹ *SEC v Trikilis* Federal Securities Law Reporter (CCH) [1992 Transfer Binder] §97,015.

Primary insiders. Under the US case law, primary insiders are persons who:

- have some fiduciary or similar duty to the company whose securities are traded by virtue of their position in the company,⁴⁶⁰ or by virtue of their temporary relationship to the company⁴⁶¹ (the fiduciary duty rationale) or
- have some fiduciary or similar duty to the counterparty⁴⁶² (also the fiduciary duty rationale) or
- have some fiduciary or similar duty to the source of the inside information, where that source is not the company whose securities are traded (the misappropriation rationale).⁴⁶³

Secondary insiders. Secondary insiders (referred to in US law as tippees) are persons who receive inside information from persons who they know are primary insiders (referred to in US law as tippers).

Liabilities of insiders

⁴⁶⁰ These persons include directors, officers, employees and controlling shareholders of the company. These individuals have various fiduciary duties under US corporate law to the corporation and its shareholders, including a duty of confidentiality and a duty of loyalty. The latter includes avoiding self-dealing, for instance, by using corporate information for personal gain. SEC Rule 10b5-2, introduced in October 2000, sets out various circumstances where misuse of a family or other non-business relationship may give rise to liability under the misappropriation rationale of insider trading. This SEC Rule overcomes the decision in *United States v Chestman* 947 F 2d 551 (1991), which held that a marital relationship, by itself, does not involve a confidential relationship with respect to company information passed from one spouse to the other.

⁴⁶¹ Temporary insiders of a company are otherwise independent persons who are rendering professional services to the company. These persons may include underwriters, lawyers, accountants, investment bankers, financial advisers and other consultants to a company. In *Dirks v SEC* 463 US 646 (1983) at 655, the US Supreme Court acknowledged that persons who are otherwise independent may be treated as insiders where (a) a special confidential relationship exists pursuant to which the adviser has access to information which is being provided to him or her solely for corporate purposes (b) an expectation (implicit or explicit) arises out of the relationship that the information will be kept confidential and (c) there must be an express or implied assent to this fiduciary relationship.

⁴⁶² An example of a fiduciary duty being owed to a counterparty would be a company buying back its shares in the market. Under US corporate law, the company owes a fiduciary duty to the shareholders who are selling their shares. The company would engage in insider trading, in violation of the fiduciary duty rationale, if it bought back shares without disclosing inside information regarding them: *Shaw v Digital Equipment Corp* 82 F.3d 1194 (1996). Another example of a fiduciary duty to a counterparty would be where investment advisers trade with their clients.

⁴⁶³ See, for instance, *United States v O'Hagan* 117 S Ct 2199, 521 US 642 (1997), *SEC v Falbo* 14 F.Supp. 2d 508 (1998).

This fiduciary relationship most commonly arises where the insider is an employee of the entity that owns the information. In other circumstances, it must be established that the alleged insider was under a fiduciary duty and accepted that duty, either expressly or by necessary implication. SEC Rule 10b5-2 provides a non-exclusive definition of when a fiduciary relationship of this nature arises in family situations. For instance, the duty applies whenever persons involved in the communication of non-public information “have a history, pattern or practise of sharing confidences, such that the person communicating the material non-public information has a reasonable expectation that the other person would maintain its confidentiality”.

The US case law applies the most complex tests of all the jurisdictions discussed in this Paper for determining the liabilities of insiders. These tests in many ways narrow the circumstances in which persons are potentially liable for trading, disclosing or procuring, compared with those in other jurisdictions.

Trading

Non-takeover context. Primary insiders are prohibited from trading in a company's securities while in possession of material non-public information about those securities if that trading would breach a duty under the fiduciary or misappropriation rationales.⁴⁶⁴ However, trading is permitted with the consent, or (in misappropriation cases) the prior knowledge, of the person to whom that duty is owed. This can reduce the ambit of the insider trading provisions.⁴⁶⁵

⁴⁶⁴ The prosecution must establish that the defendant's trading constituted a breach of that duty and threatened or caused some injury to the party owed that duty.

One form of injury is reputational injury. For instance, in *United States v Carpenter* 791 F.2d 1024 (1986), a reporter for the *Wall Street Journal* traded in advance of recommendations in his newspaper column. The journalist was convicted of insider trading under the misappropriation theory, based on the finding that he had breached the Journal's policy prohibiting personal use of information produced or derived on behalf of the newspaper. The newspaper suffered reputational injury when the public became aware of that trading.

In some instances, the courts have resorted to what appears to be artificial reasoning to establish both the duty and the resulting damage. For instance, in *United States v Willis* 737 F.Supp. 269 (S.D.N.Y., 1990), a psychiatrist traded on the basis of confidential information about the securities of a particular company, which was learned from a patient who was a director of that company. The Court held that the actions of the psychiatrist:

“jeopardised the psychiatrist-patient relationship and put at risk the patient's financial investment in psychiatric treatment, either by provoking the termination of the relationship and increasing the cost of treatment by requiring that [the patient] find a new psychiatrist, or by requiring additional treatment time to discuss the impact of [the psychiatrist's actions] on their relationship” (at 274).

⁴⁶⁵ In *United States v O'Hagan* 117 S Ct 2199, 521 US 642 (1997), the Supreme Court emphasised that there can never be misappropriation if the fiduciary has fully disclosed to the principal his intention to trade. Likewise, the person to whom the duty is owed can consent to the trade. D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §6.05[3] at 6-33 to 6-35, comments that:

“Perhaps the most troublesome question is whether high level officials of a company can approve of or acquiesce in trading by an employee in the stock of an unrelated company so as to insulate the trader from liability under the misappropriation theory (eg, the *Wall Street Journal* adopting a policy that would permit employees to trade [see the previous footnote]). The answer is ‘yes’, so long as the approving official has actual authority to approve the conduct on behalf of the corporation and is not subject to a conflict of interest. In this sense, senior management of a company about to propose a merger with another could give permission to particular insiders to trade in the subject company's stock; so long as there was full and informed consent by senior management, there would be no breach of duty, much less any fraud or deception. However, if the approving official in any way stands to benefit from the trading, he would lose the authority to approve on behalf of the company. Thus, members of a board of directors could not sequentially authorise each other to trade; such authorisation would be tainted and the corporation would be defrauded by the resulting trading.

Another loophole ... is where the employee simply announces his intent to trade to the employer. This could occur most plausibly in the setting where the employee is willing to resign ... in order to capture the insider trading profits.”

Primary insiders may lawfully refrain from trading (or cancel orders to trade) in light of inside information.⁴⁶⁶

A secondary insider breaches the insider trading prohibition by trading only when he or she knows, or should know, that:

- the information given to them is inside information
- the primary insider passed on that information in breach of the primary insider's fiduciary duty,⁴⁶⁷ and
- the primary insider has derived a direct or indirect personal benefit in so doing.⁴⁶⁸

The rationale developed by the courts for these two requirements is that secondary insiders should only be liable for trading (and primary insiders be liable as accessories to that trading) where the primary and secondary insiders have joined together in some form of "co-venture" to exploit inside information for personal gain. Arguably, to extend liability to secondary insiders may impede the free flow of information in the marketplace.

A contrary view is that the co-venture concept should be abandoned.⁴⁶⁹ For instance, why should a secondary insider be entitled to trade where a primary insider discloses

⁴⁶⁶ Rule 10b-5 only applies to the purchase or sale of a security.

⁴⁶⁷ In *SEC v Switzer* 590 F.Supp. 756 (1984), the defendant tippee was acquitted of insider trading based on a discussion he had overheard between a company director and the director's wife while seated in a public place. The Court held that the director (the involuntary tipper) did not breach any fiduciary duty for his personal benefit in having the conversation with his wife which, inadvertently, provided the inside information to the tippee.

⁴⁶⁸ There are three types of possible personal benefit:

- *pecuniary benefit*, including, for instance, a portion of the recipient's profits gained or losses avoided by the trading
- *reputational benefit*, that is, giving the information in order to enhance one's ability to gain something of value in the future, and
- *gift*, that is, the "tip and trade resemble trading by the insider himself followed by a gift of the profits to the recipient": *Dirks v SEC* 463 US 646 (1983) at 664.

In *Dirks v SEC*, the Court held that there was no direct or indirect personal benefit. In that case, a company employee (the tipper) provided an investment analyst (the tippee) with material non-public information in order to expose fraudulent business practices by his employer. The tippee did not himself trade on the information but passed the information to several of his clients (sub-tippees) who sold their shares in the company, thereby avoiding the losses that they would have otherwise suffered when the fraud was publicly exposed. The Court held that one of the prerequisites for tippee liability was that the tipper have passed the inside information to the tippee for the tipper's benefit. In *Dirks*, the tipper had gained no direct or indirect personal benefit from passing on the information (given that the motivation was simply to expose the fraud). Consequently, the tippee and sub-tippees would not have been liable for any trading.

Despite the holding in this case, the Court in *Dirks* gave an expansive interpretation of personal benefit, including situations where primary insiders enhance their own reputation by tipping or gaining the "warm glow" that comes from making a gift of the information.

In *SEC v Maio* 51 F.3d 623 (1995), the Court took into account a long pattern of friendship and gift-giving between the primary and secondary insiders in concluding that the primary insider had derived an indirect benefit from the trading of the secondary insider.

⁴⁶⁹ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §6.07 at 6-39 refers to a number of recent misappropriation cases that have sought to

inside information without deriving any consequential benefit?⁴⁷⁰ Also, proving the two co-venture requirements may be difficult where there are possible independent commercial reasons for the primary insider's actions in disclosing confidential information to the secondary insider.⁴⁷¹

It appears that any other person who receives inside information from a secondary insider (a sub-tippee) is prohibited from trading only where that person is aware that the information is material and non-public and knows, or has reason to know, that the information was obtained by virtue of a breach of fiduciary duty by the primary insider.⁴⁷² This can create practical problems for a sub-tippee who receives suspicious information.⁴⁷³

Secondary insiders may lawfully refrain from trading (or cancel orders to trade) in light of inside information, given that the legislation only covers transactions in securities.

Takeovers. A separate trading prohibition applies in the context of takeover bids. SEC Rule 14e-3 prohibits any person (other than the bidder) who possesses material

abandon the requirement that the primary insider derived a direct or indirect personal benefit in passing on the information. These cases suggest that a secondary insider "should be precluded from benefiting from information that he knows or has reason to know was obtained or used unlawfully, regardless of any sense of conspiracy or co-venture between informant and recipient".

⁴⁷⁰ An example might be a primary insider who inadvertently, and without receiving any benefit, discloses inside information at a social gathering. The listeners (secondary insiders) would be free to trade, notwithstanding the impact this might have on market fairness and market efficiency.

⁴⁷¹ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §4.03 at 4-13 and 4-14 gives the example of a financial analyst who has arranged a meeting with a corporate executive to discuss various investment-related matters. During the conversation, the executive (the primary insider) releases inside information to the analyst (the secondary insider), who subsequently trades. The author suggests that: "The communication should be protected [from insider trading liability] even if it results in trading only where *both* the [primary] insider's purpose and chosen method of communication reasonably pursue a goal other than facilitating trading by the [secondary insider]".

⁴⁷² *id.*, §4.04[3][a] at 4-23 to 4-24.

An example of sub-tippee liability may be where a sub-tippee wishes to ascertain whether the tip received is genuine before trading, for instance, by learning the original source of the information and how the information came into the tipper's hands. In this case, the sub-tippee could be said to be knowingly in possession of inside information that the sub-tippee knew, or should have known, was passed on in breach of the primary insider's fiduciary duty.

⁴⁷³ *id.*, at §4.04[3][b] at 4-28 ff discusses the responsibilities of a sub-tippee who receives suspicious information. The author criticises the suggestion in *United States v Musella* 678 F.Supp. 1060 (1988) that the sub-tippee must abstain from trading unless and until some affirmative determination is made that the information is not privileged:

"In an environment where rumors are rampant, any attempt to investigate the source seems impracticable, and would probably be fruitless. Is the only safe course, then, not to trade? For members of the public, this may be possible, but it is hardly a means of encouraging investment. And for investment professionals ... avoiding all trading and recommendations with respect to all stocks about which they hear some suspicious information is hardly feasible".

The author suggests that:

"The more sensible approach to take to the question of remote [sub-tippee] liability is to impose liability when the [sub-tippee] (1) knows enough about the source of the information that the possibility that it has been obtained or is being used improperly is clear and (2) has some opportunity to ask questions when there is a reasonable ambiguity but deliberately refrains from doing so" (at 4-30).

non-public information relating to a proposed or current tender offer⁴⁷⁴ from trading in target company securities if:

- the bidder has commenced or has taken a “substantial step” towards commencing the bid⁴⁷⁵
- the person possessing the information (the informed person) knows or has reason to know that the information was acquired directly or indirectly from the bidder, the target company or any officer of those entities,⁴⁷⁶ and
- the informed person knows or has reason to know that the information is non-public.

Where all these elements are satisfied, the informed person is prohibited from trading or divulging the confidential information to another person where it is reasonably foreseeable that the recipient will trade.⁴⁷⁷ Any informed recipient is also prohibited

⁴⁷⁴ Material non-public information during the course of the bid may include information that the bidder is about to change the terms and conditions of the bid (for instance, by converting a conditional bid into an unconditional bid or by withdrawing its offer, where this is permissible).

⁴⁷⁵ The takeover bid must be something more than just a speculative possibility, although it need not be a certainty.

According to the SEC, the phrase “substantial step” includes (but is not limited to):

“voting on a resolution by the [bidder’s] board of directors relating to the tender offer; the formulation of a plan or proposal to make a tender offer by the [bidder] or the person(s) acting on behalf of the [bidder]; or activities which substantially facilitate the tender offer such as: arranging finance for a tender offer; preparing or directing or authorising the preparation of tender offer materials; or authorising negotiations, negotiating or entering into agreements with any person to act as a dealer manager, soliciting dealer, forwarding agent or depository in connection with the tender offer” (quoted in D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §7.02[1] at 7-3).

In *SEC v Mayhew* 123 F.3d 44 (1997), a personal consultant learned of “serious” discussions regarding a merger or acquisition deal between the company to which he was a consultant and some unnamed partner. He purchased shares in the company. Two months later, the tender offer for that company was issued. The defendant claimed that at the time he purchased the securities the planning was too tentative to satisfy the “substantial step” test and, in any event, the two month delay negated any connection between the steps that he took before he transacted and the later takeover bid. The Court rejected both arguments, finding that the company, before the defendant traded, had retained a consulting firm, signed a confidentiality agreement and was having ongoing meetings with top officials of the prospective bidder. The defendant was convicted.

⁴⁷⁶ This requirement is designed to protect persons who simply hear general marketplace rumours without specific knowledge of their source. However, the courts may infer that the informed person was aware of the source. For instance, in *SEC v Musella* 748 F.Supp. 1028 (1989), the Court held that the defendant was a sufficiently sophisticated investor to know that the source of the information was either the intending bidder or someone acting on its behalf.

The SEC has said that the phrase “reason to know” should not “be construed to indicate that the person who trades or causes a transaction does not necessarily have a duty of inquiry with respect to the information and its source”. D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §7.02[4] at 7-9 takes the view that this duty of inquiry “should be limited to situations where one or more ‘red flags’ places the recipient of the information on notice that there is a substantial possibility that the information has been leaked or tipped”.

⁴⁷⁷ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §7.04 at 7-13 comments that:

from trading. There is an exception for any communications made in good faith to the officers, directors, agents, advisers or employees of the bidder or target company in connection with the bid.

Unlike the US case law on insider trading generally, this SEC rule is not based on any breach of fiduciary duty or misappropriation. It is therefore considerably wider in its application, as can be seen from *United States v Chestman*.⁴⁷⁸ In that case, a senior company official told his sister that a tender offer was about to be made for his company. His sister passed the information to her daughter. The daughter then passed it to her husband, who in turn disclosed the information to his stockbroker. The stockbroker then purchased the company's shares for his personal and his customers' accounts. The stockbroker was found not guilty of insider trading under the general provision, as there was insufficient evidence of a breach of fiduciary duty between the tipper and the company whose securities were traded. However, the stockbroker was convicted under SEC rule 14e-3, as his trades were based on possession of information related to a tender offer that he knew or had reason to know was non-public and was supplied (directly or indirectly) by an insider.

Given the much broader ambit of the SEC Rule, the distinction between those activities that fall within the SEC Rule and those that fall within the general insider trading law is particularly important. For instance, it appears that the SEC rule only applies where the informed person is aware that the information relates to a proposed or current takeover bid.⁴⁷⁹

“The SEC Release states that the Rule ‘is not intended to have an impact on casual and innocently motivated social discourse’. Rather, circumstances relating to the ‘identity, position, reputation or prior actions’ of the listener or listeners must be such that a reasonable person would suspect the possibility that the information would be used for profit. What that means, presumably, is that an insider is safe if he simply ‘lets slip’ confidential information to friends or associates. But once he is aware that potential listeners are active investors, or regularly in contact with active investors, then he must be careful to keep the information to himself”.

⁴⁷⁸ 947 F.2d 551 (1991).

⁴⁷⁹ In *SEC v Trikalis* Federal Securities Law Reporter (CCH) [1992 Transfer Binder] §97,015, an employee of a proposed target company advised a family member to buy shares in that company. The employee said that there were “corporate developments” likely to increase the price of those shares, but did not disclose the existence of the forthcoming friendly acquisition. The Court ruled that Rule 14e-3 did not apply to those family members who knew of the employee’s advice, but had no knowledge that it related to a tender offer.

By contrast, in *SEC v Mayhew* 123 F.3d 44 (1997), the Court held that Rule 14e-3 applied to defendants who knew that serious discussions were going on regarding a possible merger or acquisition, but without being aware of the method by which that merger or acquisition would take place.

Disclosing inside information

Primary and secondary insiders are liable for disclosing inside information to recipients only where that disclosure breaches a fiduciary or like duty owed by the disclosing person either to the company whose securities are traded or to the owner of the inside information and the disclosure is made for that person's direct or indirect personal benefit. Where these elements are satisfied, the primary or secondary insider is liable, whether or not the recipient was aware that the information disclosed was confidential and price-sensitive and that the disclosure involved a breach of fiduciary duty by the disclosing person.⁴⁸⁰

In the takeover context, it needs to be shown that it is reasonably foreseeable that the recipient would subsequently trade.⁴⁸¹ In other circumstances, the better view is that a breach will occur only where the recipient actually trades.⁴⁸²

Procuring transactions

A primary or secondary insider is liable for recommending or encouraging transactions by a recipient only where there is a breach of the same fiduciary duty and direct or indirect personal benefit prerequisites that apply to disclosing inside information. However, this liability for procuring transactions does not require that the inside information be disclosed to the recipient.

Research and analysis

In the leading US decision, *Dirks v SEC*,⁴⁸³ the Court held that an analyst who questioned corporate employees about rumours of possible fraudulent activities in the company, and then discussed his findings with some clients, who subsequently sold their securities in that company, did not breach the US insider trading rules. The Court ruled that the analyst had obtained material non-public information from diligent research. To prohibit this activity through the insider trading laws:

“could have an inhibiting influence on the role of market analysts, which ... is necessary to the preservation of a healthy market. It is commonplace for analysts to ‘ferret out and analyse information’ and this is often done by meeting with and questioning corporate officers and others who are insiders”.⁴⁸⁴

On-market and off-market application of insider trading prohibition

⁴⁸⁰ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §4.06 at 4-33 points out that the civil penalty under the Insider Trading and Securities Fraud Enforcement Act 1988 could be imposed on a primary or secondary insider who discloses inside information, even though that person misled the recipient about whether the information conveyed was non-public or whether the disclosure breached a fiduciary duty. The author gives the example of a primary insider who, knowing that he will inherit a relative's fortune, tells the relative that the company has just announced a new discovery, which leads to the relative buying its stock, when in fact the discovery has not yet been announced.

⁴⁸¹ Rule 14e-3 prohibits insider trading in the context of tender offers. Under this Rule, the communication of inside information is prohibited where it is reasonably foreseeable that the communication is likely to result in a violation of the rule.

⁴⁸² Rule 10b-5 prohibits fraud only in connection with the “purchase or sale” of a security.

⁴⁸³ 463 US 646 (1983).

⁴⁸⁴ *id* at 658.

The US criminal insider trading laws apply to all on-market and off-market trading in securities. However, the SEC's statutory power to impose civil penalties only applies to trading "on or through the facilities of a national securities exchange or from or through a broker or dealer". This emphasises the role of the SEC in protecting the integrity of the impersonal marketplace.⁴⁸⁵ Parties to off-market face-to-face transactions also have statutory civil remedies (see **Private civil remedies**, post).

An entity issuing its own securities

US Rule 10b5-1 (see post) enables companies to make new share issues, provided that directors reach the decision to issue securities before obtaining the inside information and they have no further discretion over the share issue scheme.

An entity purchasing its own securities

US companies that engage in share buy-backs while in possession of inside information are potentially liable for insider trading under the fiduciary duty rationale.⁴⁸⁶ To make these buy-back powers more workable, US Rule 10b5-1 (see post) now permits companies to engage in buy-backs without running the risk of insider trading, provided that the directors make the buy-back decision before obtaining any inside information and they have no further discretion over the scheme.

Use of inside information

The US courts and the SEC have considered the question of a use requirement.

In one case, the Court upheld the SEC contention that liability was established merely on proof that a trade was conducted by a defendant who knowingly possessed material non-public information. The prosecution did not need to prove that the insider used the information in formulating his or her trading.⁴⁸⁷

Subsequent US cases held that "use" of inside information as well as "possession" of that information must be proved in both civil⁴⁸⁸ and criminal⁴⁸⁹ proceedings. These

⁴⁸⁵ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §8.02[1] at 8-7.

⁴⁸⁶ Under US corporate law, companies that engage in share buy-backs owe a fiduciary duty to shareholders who sell their shares to the company under that scheme: *Shaw v Digital Equipment Corp* 82 F.3d 1194 (1996).

⁴⁸⁷ *US v Teicher* (1993) Federal Securities Law Reporter 97,781.

⁴⁸⁸ *SEC v Adler* (1998) Federal Securities Law Reporter 90,177. In this case, the Court ruled that a defendant may introduce evidence of pre-existing plans or other innocuous reasons for transacting in order to rebut a charge of insider trading. The Court also discussed (at 90,600-90,601) whether this would impose too great a burden on the SEC:

"Of the several arguments in support of the knowing possession test [as in *US v Teicher* (1993)], the strongest is the fact that it often would be difficult for the SEC to prove that an alleged violator actually used the material non-public information; the motivations for the trader's decision to trade are difficult to prove and peculiarly within the trader's knowledge. However, we believe that the inference of use, which arises from the fact that the insider traded while in knowing possession of material non-public information, alleviates the SEC's problem. The inference allows the SEC to make out its prima facie case without having to prove the causal connection with more direct evidence.... The insider can attempt to rebut the inference by adducing evidence that there was no causal connection between the information and the trade - ie, that the information was not used.

cases recognised that a “use” requirement renders prosecution more difficult, given the need to prove that the suspected insider trader actually used the material non-public information in consummating the transaction.

In response to these judicial decisions, the SEC introduced a new Rule 10b5-1, in force from October 2000.⁴⁹⁰ The Rule, which overrides the previous case law, provides that an insider is liable if that person trades “on the basis of” material non-public information. A person so trades if the person making the purchase or sale “was aware of the material, nonpublic information when the person made the purchase or sale”. In consequence, the prosecution need not also establish that the insider used the information.

However, Rule 10b5-1 sets out various specific defences to liability where the inside information is not a factor in the decision to trade. These defences are designed to provide specific guidance on how a person can lawfully plan future transactions at a time when he or she is not aware of material nonpublic information. They permit persons to structure securities trading plans, including selective buy-backs or employee share plans, which may be implemented at any future time, provided that those persons are not aware of material nonpublic information at the time of devising the plan.

Under subparagraph (c) “Affirmative defenses” of the new Rule 10b5-1, an insider may trade in the affected securities prior to public release of inside information if that person can establish the following three elements:

- “(A) before becoming aware of the information, the person had: (1) entered into a binding contract to purchase or sell the security, (2) instructed

The factfinder would then weigh all the evidence and make a finding of fact as to whether the inside information was used.”

In this case, the Court ruled that certain transactions did not constitute insider trading, given the defence evidence that the decision to enter into these transactions pre-dated the acquisition of the material non-public information. By contrast, another transaction was held to constitute insider trading. The Court (at 90,605) rejected the argument that the defendant’s “purchase of the put options was consistent with evidence of his prior trading in options and other high risk investments. This evidence is clearly not sufficient to rebut the reasonable inference that [the defendant] possessed and traded on the basis of material non-public information.”

⁴⁸⁹ *US v Smith* (1998) Federal Securities Law Reporter 90,274. The Court in this case imposed a “causal connection” requirement. It ruled that the prosecution must demonstrate that the defendant actually used material, non-public information in consummating his transaction. The Court (at 91,244) reasoned that it is the insider’s use, not possession, of insider information that gives rise to informational advantage and the requisite intent to defraud:

“The persons with whom a hypothetical insider trades are not at a ‘disadvantage’ at all provided the insider does not ‘use’ the information to which he is privy. That is to say, if the insider merely possesses and does not use [the inside information], the two parties are trading on a level playing field; if the insider merely possesses and does not use [the inside information], both individuals are making their decisions on the basis of incomplete information.”

The Court also ruled (at 91,245) that, in a criminal prosecution (unlike the civil proceedings in *SEC v Adler*), the onus remains on the prosecution to:

“demonstrate that the suspected insider trader actually used the material, non-public information in consummating his transaction.”

⁴⁹⁰ SEC Release No 33-7881 (October 2000).

another person to purchase or sell the security for the instructing person's account, or (3) adopted a written plan for trading securities;

(B) the contract, instruction, or plan:

- (1) specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; [or]
- (2) included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
- (3) did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who, pursuant to the contract, instruction, or plan, did exercise such influence must not have been aware of the material nonpublic information when doing so; and

(C) the purchase or sale that occurred was pursuant to the contract, instruction, or plan. A purchase or sale is not 'pursuant to a contract, instruction, or plan' if, among other things, the person who entered into the contract, instruction, or plan altered or deviated from the contract, instruction, or plan to purchase or sell securities (whether by changing the amount, price, or timing of the purchase or sale), or entered into or altered a corresponding or hedging transaction or position with respect to those securities".

The above exclusion will only apply if the contract, instruction or plan to purchase or sell securities was given or entered into in good faith and not as part of a plan or scheme to evade the insider trading prohibitions.

The SEC Commentary on Rule 10b5-1 describes its purpose and illustrates its workings as follows:

"Taken as a whole, the revised defence is designed to cover situations in which a person can demonstrate that the material nonpublic information was not a factor in the trading decision. We believe this provision will provide appropriate flexibility to those who would like to plan securities transactions in advance at a time when they are not aware of material nonpublic information, and then carry out those pre-planned transactions at a later time, even if they later become aware of material nonpublic information.

[*Buy-backs*] For example, an issuer operating a repurchase program will not need to specify with precision the amounts, prices, and dates on which it will repurchase its securities. Rather, an issuer could adopt a written plan, when it is not aware of material nonpublic information, that uses a written formula to derive amounts, prices, and dates. Or the plan could simply delegate all the discretion to determine amounts, prices, and dates to another person who is not

aware of the information - provided that the plan did not permit the issuer to (and in fact the issuer did not) exercise any subsequent influence over the purchases or sales.

[*Employee purchase plans*] An employee also could acquire company stock through payroll deductions under an employee stock purchase plan. ... The employee could provide oral instructions as to his or her plan participation, or proceed by means of a written plan. The transaction price could be computed as a percentage of market price, and the transaction amount could be based on a percentage of salary to be deducted under the plan. The date of a plan transaction could be determined pursuant to a formula set forth in the plan. Alternatively, the date of a plan transaction could be controlled by the plan's administrator or investment manager, assuming that he or she is not aware of the material, nonpublic information at the time of executing the transaction, and the employee does not exercise influence over the timing of the transaction.

[*Employee disposition plans*] Similarly, 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."

Derivative civil liability

Any person who is in a position to control another person may be subject to derivative civil liability for any impermissible trading or tipping by that other person. That liability may be up to three times the profit gained or loss avoided by the insider or the insider's direct tippee.⁴⁹¹ A "controlling person" is any person with power to influence or control the direction or the management, policies or activities of another person. Control is inferred from possession of such power, whether or not it is exercised.⁴⁹²

A controlling person has derivative civil liability for any insider trading or tipping breach by a controlled person where it is established that:

"the controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred".⁴⁹³

In consequence, a controlling person may not deliberately disregard circumstances suggesting that a controlled person is breaching the insider trading provisions. The clearest example of reckless disregard would be where a controlling person has no, or

⁴⁹¹ Insider Trading and Securities Fraud Enforcement Act s 21A(a)(3).

⁴⁹² D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §8.02[2][b] at 8-16.

⁴⁹³ Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(A).

an apparently inadequate, internal system to control access to, or dissemination of, confidential price-sensitive information, where such information exists or is likely to exist.

The express rationale for imposing derivative liability is that insider trading may be an institutional, as well as an individual, problem:

“Firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility.”⁴⁹⁴

Controlling persons who are securities issuers may take various preventative steps to avoid derivative liability, including education of employees, controls over the internal dissemination of confidential price-sensitive information and reporting and other internal controls over trading in their own securities, particularly short selling or options trading in those securities. These precautions may help to rebut any claim that the securities issuer recklessly disregarded the risk of illegal insider trading by its employees.⁴⁹⁵

Other organizations such as law or accounting firms or banks that regularly come into possession of material non-public information could also take preventative steps to minimise the possibility of insider trading abuse and any derivative liability. These steps could include prohibiting or controlling transactions in the securities of particular clients, internal reporting requirements for securities trading by partners or employees, and requirements that any securities trading be executed through a designated brokerage firm.⁴⁹⁶

A controlling person may also be jointly liable in any private civil suit brought against an insider trader “unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action”.⁴⁹⁷ One commentator suggests that a controlling person may be liable if there has been a reasonably serious breakdown in (or the non-existence of) the sorts of controls that such a person could be expected to adopt to deal with the problem of insider trading.⁴⁹⁸

US brokers or investment advisers have an additional basis for derivative liability. They may be civilly liable for any insider trading or tipping breach by an employee where they knowingly or recklessly failed to establish, maintain or enforce written policies and procedures reasonably designed to prevent the misuse of material non-public information, and that failure substantially contributed to or permitted the

⁴⁹⁴ 1988 US House of Representatives Report into the Insider Trading and Securities Fraud Enforcement Act at 14-15.

⁴⁹⁵ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.03[1][b] at 12-12 to 12-16.

⁴⁹⁶ *id.*, §12.03[2] & 12.03[3] at 12-27 to 12-34.

⁴⁹⁷ Insider Trading and Securities Fraud Enforcement Act 1988 s 20(a).

⁴⁹⁸ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.03[1][c] at 12-16 to 12-21.

occurrence of the act or acts constituting the violation.⁴⁹⁹ This nexus between the failure of the supervisory system and the insider trading is established on proof that the breakdown or failure permitted or provided some assistance to the underlying violation.⁵⁰⁰

Regulator's remedies

Criminal prosecutions for insider trading are undertaken by the US Justice Department.⁵⁰¹ In addition, the SEC may bring civil actions against suspected violators,⁵⁰² or persons with derivative liability.

In addition to injunctive remedies, the SEC may seek disgorgement of any profit obtained or loss avoided as a result of insider trading and a civil monetary penalty of up to three times the profit gained or loss avoided by an insider trader.⁵⁰³ In consequence, an insider trader faces potential civil liability of up to four times the profit gained. A primary insider is liable for some or all of the profits made by a secondary insider's illegal trading, even where the primary insider receives no financial benefit.⁵⁰⁴

To measure profits gained or losses avoided in a securities transaction, for the purpose of disgorgement of profits or imposing a monetary penalty, the court must calculate the difference between the price paid by the insider (if purchasing) or the price received by the insider (if selling) and the trading price of those securities within a reasonable period after public dissemination of the information. This formulation, as it applies to purchases and subsequent sales by insiders, was preferred over a measurement based on the difference between the defendant's purchase price and the defendant's eventual sale price.⁵⁰⁵ The rationale is that, once the inside information is released, an insider no longer possesses any informational advantage. That person is free to enter the market and trade, and any profit or loss coming after that point was not unjustly obtained.

⁴⁹⁹ Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(B). The elements of this statutory requirement are analysed in D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §12.05 at 12-39 to 12-44.

⁵⁰⁰ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §8.02[2][c] at 8-23.

⁵⁰¹ Criminal prosecutions may be commenced under the Securities Act 1933 s 17, which is virtually identical to Rule 10b-5. Insiders may also be liable under s 32(a) of the Securities Exchange Act., under federal mail and wire fraud provisions, and under the Racketeer Influenced and Corrupt Organizations Act (RICO).

⁵⁰² In *Hudson v United States* 522 U.S. 93 (1997), the Court held, in effect, that the SEC could pursue civil penalty actions, regardless of parallel criminal proceedings, without this constituting double jeopardy.

⁵⁰³ Insider Trading Sanctions Act 1984 s 21A.

⁵⁰⁴ One of the requirements for secondary insider liability is that the primary insider acted for his or her own "personal benefit", which need not necessarily be a financial benefit. Given this, it is seen as appropriate to deprive the primary insider of the monetary equivalent of that benefit which may be any amount up to the equivalent of the trading profits of the secondary insider.

⁵⁰⁵ Thus, for instance, if an insider buys shares at \$5 per share, watches the share price increase to \$10 per share upon public dissemination of the inside information, but does not sell until six months later at \$15 per share, the gain is \$5 per share, not \$10 per share. Conversely, if six months later the price for those shares had fallen to \$3 per share, so that there is no actual profit when the shares are sold, there is still a paper profit of \$5 per share on which the penalty is based.

Funds received by the SEC in these civil actions (less administrative and litigation costs) are held for the benefit of those adversely affected by the illegal activity, primarily those who suffered net out-of-pocket losses in contemporaneous trading with the insider.

To assist the investigative process, the SEC may pay a bounty to informers of up to 10% of any penalty collected by the Commission.⁵⁰⁶ This power is controversial. On the one hand, it may assist the SEC to identify and investigate possible insider trading. On the other hand, bounty payments might frustrate firms' own internal compliance systems, in that individuals may hesitate to report suspicious conduct internally lest they lose the ability to claim a bounty. The SEC, in 1997, commented that:

“The Commission’s bounty program ... has not really developed as a significant source of either leads or cases”.⁵⁰⁷

Contemporaneous traders

An insider is liable to any person who:

“contemporaneously with the purchase or sale of securities that is the subject of such violation has purchased (where such violation is based on a sale of securities) or sold (where such violation is based on a purchase of securities) securities of the same class”.⁵⁰⁸

The legislation intentionally does not define what is contemporaneous trading. Rather, what constitutes contemporaneous trading was left to the courts to develop in light of changing market practices and trading technology. However, the case law is neither settled nor fully consistent. Some commentators suggest that, in a widely traded security, contemporaneous trading would be any trading that takes place within a few days of the insider’s trading activities, though some case law suggests that trading would have to take place within one day of those activities to be contemporaneous.⁵⁰⁹

It is unclear whether a person who trades immediately before the insider’s unlawful trading has standing to sue. One judicial view is that any person who trades before the insider, even on the same day, has no cause of action, as an insider commits no wrongdoing until he or she begins dealing in securities.⁵¹⁰

⁵⁰⁶ Insider Trading and Securities Fraud Enforcement Act 1988. Informers can include brokerage firms, which thus have an incentive, in addition to derivative civil liability, to monitor the activities of their employees.

⁵⁰⁷ “Special Report – Microcap Fraud, Staffing Issues Top Enforcement Agenda” 29 *Securities Regulation and Law Reporter* (BNA) (19 December 1997) 1769 at 1772.

⁵⁰⁸ Insider Trading and Securities Fraud Enforcement Act 1988 s 20A(a).

⁵⁰⁹ M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 31, D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §9.02[1] at 9-9, L Loss and J Seligman, *Securities Regulation* (3rd edn, Little, Brown & Company) vol VIII at 3724.

⁵¹⁰ *O’Connor & Associates v Dean Witter Reynolds Inc* 745 F.Supp. 1511 (1990). See further D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §9.02[2] at 9-10.

The American Law Institute draft Securities Code (which is a model Code only) has the broadest test of contemporaneous trading. It classifies as an eligible claimant any person:

“who buys [or sells] during the period beginning at the start of the day when the [insider trader] first unlawfully sells [or buys], and ending at the end of the day when all material facts ... become generally available”.⁵¹¹

Civil remedies

The total amount of damages awarded in private civil litigation cannot exceed the profit gained or loss avoided in the transaction or transactions by the insider, regardless of the number of contemporaneous traders.⁵¹² Also, the amount of damages recoverable under private civil litigation is reduced by any amount obtained by the SEC (for the benefit of affected persons) in its civil proceedings relating to the same transaction or transactions.⁵¹³

These restrictions avoid the possibility of double civil recovery, which might impose a disproportionate financial burden on defendants. However, they also significantly reduce the incentive for affected persons to undertake private civil litigation. In practice, private litigation only tends to be undertaken when the SEC has been unwilling to act.

Prohibition on short swing profits

The US legislation gives an issuer of securities (or a shareholder of the issuer in a derivative action) the right to seek recovery of any profits made by any corporate directors, executive officers or substantial shareholders (that is, persons who are beneficial owners of more than 10% of any class of equity securities) of that issuer from any purchase and sale (or sale and purchase) of the issuer's equity securities (or securities convertible into equity) in any six month period (“short-swing profits”).⁵¹⁴ This provision reduces the opportunities for such persons to gain from inside information. However, it applies without regard to whether the director, officer or substantial shareholder possessed any inside information. Civil liability is triggered simply by finding both a purchase and sale (or sale and purchase) within the statutory six month period.

Various exemptions have been introduced to reduce the potential overreach of the provision. For instance, the SEC has exempted stock option and stock ownership plans. Without this protection, various acquisitions and sales of a company's securities by corporate executives pursuant to these plans would be affected.⁵¹⁵

⁵¹¹ American Law Institute Draft Federal Securities Code §1703(b). VM Dougherty, “A[dis]semblance of Privity: Criticizing the Contemporaneous Trader Requirement in Insider Trading” 24 *Delaware Journal of Corporate Law* 83 (1999) supports this approach.

⁵¹² Insider Trading and Securities Fraud Enforcement Act 1988 s 20A(b)(1).

⁵¹³ id, s 20A(b)(2).

⁵¹⁴ Securities Exchange Act s 16(b).

⁵¹⁵ SEC Rule 16b-3.

Likewise, the courts have granted exemptions for involuntary transactions, such as purchases and sales effected under a hostile takeover bid.⁵¹⁶

The US provision is seen as a partial adjunct to the insider trading provisions. It only applies to directors, officers and substantial shareholders, not other persons within a company who may have access to confidential price-sensitive information. Also, it only applies to trades within a six month period.

Enforcement depends on the willingness of the issuer (or a shareholder in a derivative action) to bring an action. There is no public enforcement. Any private action must be brought within two years of when the affected transaction was disclosed.

⁵¹⁶ D Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §10.02[2][a] at 10-15 ff.

Appendix 7

Canada

In Canada, insider trading is governed principally by the securities legislation of the various provinces, which follow the model of the Ontario Securities Act. The federal legislation has a much more limited application.

What is inside information

The Canadian provincial securities legislation covers any material fact or material change, whether generated by the company whose securities are traded or elsewhere.⁵¹⁷

Level of precision of the inside information

The Ontario securities legislation does not use the term “specific” information. Rather, it applies to any “material fact” or “material change” that has not been generally disclosed.⁵¹⁸

The Canadian federal legislation refers to the use of “any specific confidential information” by an insider.⁵¹⁹ This term is not defined. However, on one view, the information must relate to an event that is at such an advanced stage that it is likely to occur. Breaches of the federal insider trading provisions would therefore be restricted to instances where the information is reliable and relates specifically to the corporation whose securities are traded.⁵²⁰ It has been proposed that the term “specific” be deleted from the federal legislation, as it may render proof of insider trading unduly difficult.⁵²¹

Who are insiders

The Ontario securities legislation effectively distinguishes between primary and secondary insiders.

⁵¹⁷ Ontario Securities Act s 76(1). A material fact, in relation to securities, is defined as any fact “that significantly affects, or would reasonably be expected to have a significant effect on, the market price or value of such securities”: s 1 definition of “material fact”.

⁵¹⁸ *id.*, s 76(1).

⁵¹⁹ Canada Business Corporations Act s 131(4).

⁵²⁰ The Canadian provincial corporations legislation (which has a very limited application) also applies to any “specific confidential information”: for instance, Ontario Business Corporations Act s 138(5). Examples of information which have been held to be specific under this legislation are:

- that a company will report a loss, even though the exact amount of the loss is unknown
- that there is a letter which states that a person is tentatively interested in purchasing a company at a given price
- that negotiations are under way for a takeover and that two days have been set aside for the final talks, even though the potential bid price is unknown (M Stamp & C Welsh (eds) *International Insider Dealing* (FT Law and Tax, 1996) at 55).

⁵²¹ Industry Canada, *Insider Trading Discussion Paper* (February 1996), paras [128]-[130].

Primary insiders

These include directors, other officers, employees, affiliates and associates of the company whose securities are traded and other persons who are in a special relationship with that company.⁵²²

Secondary insiders

These are any persons who in any way learn of inside information (including even by chance) from anyone who they know or ought reasonably to know is a primary insider or another secondary insider.⁵²³ The extension of the definition of secondary insiders to persons who receive information from someone they know is a secondary insider ensures that the legislation is not limited to secondary insiders who have been informed by a primary insider. It is proposed that the Canadian federal legislation adopt the same approach.⁵²⁴

Liabilities of insiders

As with the UK and South Africa, the trading, disclosing and procuring offences under the Ontario legislation apply equally to primary and secondary insiders. However, the Ontario legislation does not have the range of statutory defences that are found in the UK Act.

Trading

Under the Ontario insider trading prohibition, primary and secondary insiders are prohibited from purchasing or selling “securities of the reporting issuer with the knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed”.⁵²⁵

Disclosing inside information

The Ontario securities legislation prohibits primary and secondary insiders from disclosing any inside information to another person, other than in the necessary course of their business.⁵²⁶ It is not necessary for the recipient to have traded on the information, or for the primary or secondary insider to have expected the recipient to so trade. Unauthorised disclosure alone constitutes an offence. A similar prohibition is proposed for the Canadian federal legislation.⁵²⁷

There is a separate disclosure prohibition on any person (whether or not an insider) who is proposing:

⁵²² Ontario Securities Act s 76(5)(a)-(d). Persons in a special relationship with the company include any person that proposes to make a takeover bid for that company or acquire a substantial portion of the company’s property, or proposes to become a party to any reorganization, amalgamation, merger, scheme of arrangement or similar business combination with the company.

⁵²³ *id.*, s 76(5)(e).

⁵²⁴ Industry Canada, *Insider Trading Discussion Paper* (February 1996), paras [103]-[107]; Canada Business Corporations Act Amendment Bill (March 2000) proposes to amend s 131 of the Act to bring it into line with the provincial legislation.

⁵²⁵ Ontario Securities Act s 76(1).

⁵²⁶ *id.*, s 76(2).

⁵²⁷ Canada Business Corporations Act Amendment Bill (March 2000) s 131(6), (7).

- to make a takeover bid
- to become a party to a reorganisation, or
- to acquire a substantial portion of a company's property.⁵²⁸

Procuring transactions

The Canadian legislation contains no provision dealing with procuring.

On-market and off-market application of insider trading prohibition

The Ontario securities legislation and the federal legislation apply only to corporations any of whose securities are distributed to the public.⁵²⁹

Use of inside information

Federal legislation

The Canadian federal legislation contains a “use” requirement. It imposes liability on an insider only if that person “makes use of any specific confidential information for his own benefit or advantage”.⁵³⁰ On one view, this requirement creates an insurmountable evidentiary obstacle by allowing an insider to avoid liability by arguing that, although he or she had knowledge of the inside information and traded, that information was not a factor in the trading decision. It has been recommended that the use requirement in the federal legislation be deleted, subject to the inclusion of specific statutory defences that are found in the provincial statutes, which do not have any use requirement.⁵³¹

Ontario legislation

The Ontario securities legislation originally had a use requirement. However, that requirement was repealed in 1980 in response to criticisms that it undermined the effectiveness and enforceability of the legislation.⁵³² Instead, a number of specific defences were introduced into the legislation. These include trading pursuant to an automatic trading plan (such as a dividend re-investment plan) established prior to the acquisition of the inside information, and trading to fulfil a legally binding obligation entered into prior to the acquisition of the inside information.⁵³³

⁵²⁸ id, s 76(3). See further P Osode, ‘The Regulation of Insider Trading in Canada: A Critical Appraisal’ (1999) 28 *Anglo-American Law Review* 166 at 178.

⁵²⁹ Canada Business Corporations Act s 126(1), definition of “distributing corporation”, Ontario Securities Act s 76 and s 1 definition of a “reporting issuer”. The provincial corporations legislation provides for civil liability for any insider trading in securities of any corporation which is incorporated under the provincial legislation and which is not a reporting issuer, that is, its securities are not distributed to the public, for instance, Ontario Business Corporations Act s 138.

⁵³⁰ Canada Business Corporations Act s 131(4).

⁵³¹ Industry Canada, *Insider Trading Discussion Paper* (February 1996), paras [131]-[135].

⁵³² FH Buckley, “How to do things with inside information” (1977) 2 *Canadian Business Law Journal* 343.

⁵³³ Ontario Securities Act Regulation 1015 s 175.

It has been proposed that similar statutory defences be introduced in the federal legislation, to substitute for the use requirement. These defences would cover, for instance, automatic and non-discretionary share purchase plans. An insider who knew of inside information could be exempted if he or she purchased shares pursuant to a plan entered into before the insider obtained the inside information. The defence should not apply if the insider can decide when purchases are to be made under the plan.⁵³⁴

Regulator's remedies

Under the Ontario securities legislation, anyone who contravenes the insider trading provisions is liable to imprisonment and a fine of up to four times the profit made or loss avoided by reason of the contravention.⁵³⁵ The legislation has adopted a method of determining profit or loss for the purpose of imposing penal liability. Profit is defined in the following three ways:

- if the accused purchased securities in contravention of the insider trading provisions, the profit is the average market price of the security in the 20 trading days following general disclosure of the inside information less the amount the accused paid for the security
- if the accused sold securities in contravention of the insider trading provisions, the profit is the amount that the accused received 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 accused informed another person of the inside information in contravention of the insider trading provisions, and received any direct or indirect consideration for providing this information, the profit is the value of the consideration received.⁵³⁶

Similarly, loss avoided is defined as the amount by which the amount received for the securities sold in contravention of the insider trading provisions exceeds the average trading price of the securities in the 20 trading days following general disclosure of the inside information.⁵³⁷

Civil remedies

The Ontario securities legislation provides a civil remedy for any counterparty to an insider. The legislation uses an “average market price” formula to determine the measure of damage suffered by the counterparty where the affected securities are publicly traded. In assessing damages, the court may consider:

⁵³⁴ Industry Canada, *Insider Trading Discussion Paper* (February 1996), para [147].

⁵³⁵ Ontario Securities Act s 122(4).

⁵³⁶ *id.*, s 122(6). A similar rule is proposed for the Canadian federal legislation: Canada Business Corporations Act Amendment Bill (March 2000) s 131(8).

⁵³⁷ Ontario Securities Act s 122(6).

- if the plaintiff is a purchaser, the price paid by the plaintiff 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 plaintiff 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 plaintiff for the security.⁵³⁸

These factors seek to provide an objective formula to determine the profit gained or loss avoided by an insider. They aim to avoid the effect of short swing, and possibly inappropriate, market reactions to the disclosure of inside information.

Speculative trading by closely connected persons

In addition to the insider trading provisions, the Canadian legislation prohibits two forms of speculative trading by company directors, officers and other persons closely connected with a company (closely connected persons), namely:

- short selling in their company's securities
- transactions in various types of options over their company's securities.

These prohibitions are seen as extensions of, or complementary to, the insider trading provisions.

Closely connected persons are prohibited from short selling their company's shares, or those of an affiliate company.⁵³⁹ It has been argued that short selling by these persons is simply pure speculation by them that the price of their company's shares will decline in the short term. This may create a conflict between their personal interests and the company's interests, particularly where they are in a position to influence the company's affairs. Permitting short selling may also encourage insider trading where closely connected persons are aware of confidential information, the release of which will reduce the market price of the company's shares.⁵⁴⁰

Closely connected persons are also prohibited from selling or buying a call or put option over their company's shares or those of an affiliate company.⁵⁴¹ This prohibition reflects a policy that those insiders should not be allowed to speculate in their own company's shares or place their personal interest above the interests of their corporation.⁵⁴²

Various amendments to the Canadian speculative trading provisions have been proposed, namely that:

⁵³⁸ id, s 134(6).

⁵³⁹ Canada Business Corporations Act s 130(1), (3).

⁵⁴⁰ Industry Canada, *Insider Trading Discussion Paper* (February 1996) at para [68], quoting from materials prepared for the Canadian Parliament in 1970 explaining the policy rationale behind the prohibition on short sales by insiders in the Canada Business Corporations Act s 130(1).

⁵⁴¹ Canada Business Corporations Act s 130(2).

⁵⁴² Industry Canada, *Insider Trading Discussion Paper* (February 1996) paras [68]-[72].

- the prohibition on short selling and entering into option contracts should be extended beyond shares to all securities
- the category of closely connected persons should be limited to persons who can influence corporate decision-making (and who are therefore more likely either to have access to inside information or to be able to use their decision-making power to promote their personal interests over the company's interests), and
- the prohibition on options should be limited to the purchase of put options and the sale of call options, given that holders of these options benefit from a decline in the value of the company's shares. By contrast, closely connected persons who sell a put option or purchase a call option will only profit from the transaction if the value of the company's stock increases. A prohibition on these trades does not further the objective of eliminating conflicts.⁵⁴³

⁵⁴³ Industry Canada, *Insider Trading Discussion Paper* (February 1996) paras [65]-[87], Appendix A. These proposals are contained in the Canada Business Corporations Act Amendment Bill (March 2000).

Appendix 8

New Zealand

New Zealand introduced provisions to regulate insider trading in 1988. New Zealand is the only jurisdiction dealt with in this Discussion Paper that only provides civil remedies for breaches of its insider trading provisions.

What is inside information

The New Zealand legislation has a broad definition of inside information, namely “information which is not publicly available and would, or would be likely to, affect materially the price of the securities of the public issuer if it was publicly available”.⁵⁴⁴ It is not confined to information generated by the company whose securities are traded.

Who are insiders

The New Zealand statute effectively distinguishes between primary and secondary insiders.

Primary insiders

A primary insider of an issuer of securities includes the issuer itself, its officers, employees and substantial security holders and other persons having a direct or indirect connection with that issuer.⁵⁴⁵ Arguably, a primary insider must receive the price-sensitive information by reason of that person’s connection or relationship with the issuer.

A person is a primary insider of the securities of another corporation if that person obtains inside information in confidence either from that other corporation itself or from a primary insider of that other corporation.⁵⁴⁶

Secondary insiders

These are persons who receive inside information in confidence from a primary insider.⁵⁴⁷ However, the category of secondary insiders is limited to persons who are not more than two removes from a primary insider.⁵⁴⁸

⁵⁴⁴ New Zealand Securities Amendment Act 1988 s 2.

⁵⁴⁵ *id.*, s 3(1).

⁵⁴⁶ *Ibid.*

⁵⁴⁷ *Ibid.*

⁵⁴⁸ The New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (November 2000) paras 174 ff stated that the effect of s 3(1)(e) of the New Zealand Securities Amendment Act 1988 was that the chain of insiders does not extend further than two removes from the primary source of the information. The rationale was to prevent insider trading near the source of the information. However, it had been recognised at the time of introducing the 1988 legislation that “logic

Anomalies

Some recent reports have pointed to apparent gaps or anomalies in the definitions of primary and secondary insiders.⁵⁴⁹

Liabilities of insiders

Primary and secondary insiders have the same civil liability for trading, disclosing and procuring.

Trading

Primary and secondary insiders are civilly liable for trading in affected securities.⁵⁵⁰

Disclosing inside information

Primary and secondary insiders are civilly liable for disclosing information to a second person if they know or believe that the second person will buy or sell affected securities or that the second person will advise or encourage a third person to buy or sell those securities.⁵⁵¹

Procuring transactions

Primary and secondary insiders are civilly liable for advising or encouraging a second person to buy or sell affected securities or for advising or encouraging that second person to advise or encourage a third person to buy or sell those securities.⁵⁵²

On-market and off-market application of insider trading prohibition

The New Zealand legislation is restricted to the securities of public issuers,⁵⁵³ though a recent Discussion Paper questions whether the legislation should be extended to all issuers of securities to the public.⁵⁵⁴

suggests that a sequence of confidences could reach to infinity, and that all in a sequence, however extended, should be regarded as insiders”.

⁵⁴⁹ The New Zealand Ministry of Economic Development *Insider Trading Discussion Document* (September 2000) para 3.10 proposed extending the definition of an indirect connection to include officers of related companies.

The New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999* (November 2000) concluded (at paras 125, 151) that a person (A) who surreptitiously misappropriated confidential price-sensitive information from someone (B) who received it from a person (C) who had access to the information that was inadvertently posted on the company’s internal computer bulletin board was not an insider under the statutory definition. The Commission also concluded that B was not an insider under the statutory definition (paras 124, 151). The Commission recommended (at para 187) that the legislation be amended to include as an insider “any person who obtains or receives inside information from an insider (including a person who is an insider by reason of s 3(1)(c)) and who holds that information in circumstances importing an obligation of confidence in respect of the information”.

⁵⁵⁰ Securities Amendment Act 1988 ss 7, 11.

⁵⁵¹ *id.*, ss 9(1)(b), 13(1)(b).

⁵⁵² *id.*, ss 9(1)(a), 13(1)(a).

⁵⁵³ *id.*, s 7(1); s 2 definition of “public issuer”.

An entity issuing its own securities

A New Zealand Discussion Paper raises the question whether a company's new share issues made pursuant to a prospectus should be specifically exempt from the insider trading prohibition.⁵⁵⁵

An entity purchasing its own securities

A New Zealand Discussion Paper considers whether share buy-backs should be specifically exempt from the insider trading provisions. The Paper argues that:

“Without any exception in the statute it seems that a company may be liable as an insider where it purchases shares pursuant to a buy-back. The statutory procedure in the [New Zealand] Companies Act regulating buy-backs contains detailed restrictions on the extent to which the board can hold material price-sensitive information which is not disclosed to shareholders when making a buy-back offer. In these circumstances it has been suggested that buy-backs should be taken outside the ambit of the insider trading provisions.”⁵⁵⁶

Role of the regulator

The New Zealand legislation provides only for civil remedies at the instigation of either the affected company or any counterparty to the insider. There is no provision for the New Zealand Securities Commission to commence either criminal or civil proceedings. However, any shareholder may, with the prior approval of the Commission, require the affected company, at the company's expense, to obtain a legal opinion on whether it has a cause of action against the insider.⁵⁵⁷

Civil remedies for companies whose securities were traded

Under the New Zealand law, the company whose securities were traded or, with the leave of the court, any person who was a shareholder of that company at the time the insider trading took place may take civil proceedings against an insider.⁵⁵⁸ The maximum recoverable fund cannot exceed the consideration paid for the securities or three times the gain made or loss avoided by the insider, whichever is the greater.⁵⁵⁹

⁵⁵⁴ New Zealand Ministry of Economic Development *Insider Trading Discussion Document* (September 2000) para 3.8.

⁵⁵⁵ id, paras 3.27-3.28.

⁵⁵⁶ id, para 3.26.

⁵⁵⁷ Securities Amendment Act 1988 s 17.

⁵⁵⁸ id, ss 7(2)(c), 9(2)(g), 11(2)(c), 13(2)(g), 18.

⁵⁵⁹ id, ss 7(4), 11(4).

Any money recovered in an action by the company must be held for distribution in accordance with the directions of the court. The court may order that any amount be distributed to particular individuals (such as shareholders or former shareholders of the company or any person who would otherwise have a civil remedy against the insider), be retained by the company or be paid for charitable purposes.⁵⁶⁰

⁵⁶⁰ id, s 19.

Appendix 9

Singapore

For more than a decade, Singapore has had criminal and civil insider trading legislation based on the pre-1991 Australian provisions. New provisions, proposed by the Monetary Authority of Singapore (MAS) and now being considered by the Singapore Parliament, are based on the existing Australian law, with some modifications.

What is inside information

The relevant provisions under the proposed Securities and Futures Act 2001 are the same as the Australian law.

Level of precision of inside information

The MAS proposes that the definition of information in the Singapore legislation be widened, beyond that found in the existing Australian legislation. The proposed additional matters to be covered by the definition, based on the Malaysian legislation, are:

- “matters relating to negotiations or proposals with respect to (i) commercial dealings or (ii) dealing in securities;
- information relating to the financial performance of a body corporate or otherwise;
- information that a person proposes to enter into, or had previously entered into, one or more transactions or agreements in relation to securities or has prepared or proposes to issue a statement relating to such securities; and
- matters relating to the future”.⁵⁶¹

Who are insiders

The current legislation differentiates between primary and secondary insiders in a similar manner to the pre-1991 Australian provisions.⁵⁶²

The MAS is critical of this “person connection” approach, in particular the need to prove that a secondary insider has received information directly or indirectly from a primary insider and that the secondary insider has an arrangement or association with

⁵⁶¹ Draft Securities and Futures Act 2001 s 203 definition of “information” paras (c)-(f).

⁵⁶² Securities Industry Act 1986 (Singapore) s 103. This provision is modelled on the Australian Securities Industry Code s 128, which was adopted in the Corporations Law prior to the 1991 amendments.

that primary insider. These prerequisites have created possible gaps in the application of the legislation.⁵⁶³

The MAS has released draft legislation, which will repeal the distinction between primary and secondary insiders in favour of adopting the current Australian “information connection” only approach. It will define insiders solely in terms of their awareness of inside information:

“The new insider trading provision in the Securities and Futures Act 2001 will no longer depend on the proof of a person’s connection with the company. The test will instead shift to the core essence of the offence, ie trading while in possession of undisclosed market sensitive information by the defendant, irrespective of his connection with the company. The scope of insider trading would therefore not just be restricted to the insider and the tippee, but to all persons who knowingly possess inside information and who trade on it.”⁵⁶⁴

Liabilities of insiders

There are proposals to amend the legislation in relation to the liabilities of insiders in line with the current Australian provisions.

Trading, disclosing and procuring. The MAS proposes that the Singapore legislation be amended to reflect the general approach of the current Australian insider trading laws.⁵⁶⁵

⁵⁶³ MAS, *Insider Trading: Consultation Document* (January 2001), paras 2-4, states:

“The tippee [secondary insider] provision makes it harder for tippees to be convicted as the balance may be tilted too much in favour of tippees to the detriment of other market participants. Firstly, the prosecution has to show that the tippee has received information, directly or indirectly from a [primary] insider. Secondly, it has to be shown that the tippee had an arrangement or association with the insider. Thirdly, the tippee must be aware or ought to be aware that the insider himself is precluded from dealing.

These tippee requirements pose a legal difficulty in extending liability to others who are further down the information chain (secondary tippees and beyond). Where the tippee himself does not trade but communicates price-sensitive information to another person (the secondary tippee) who then trades in securities, it may be difficult to prove any ‘arrangement’ or ‘association’ with the insider. The secondary tippee may escape from being caught by the existing insider trading prohibition. This is unsatisfactory, as the secondary tippee (or other persons down the information chain who eventually receive information from the secondary tippee) would have traded with an unfair information advantage.

A person who receives inside information from sources *other* than a connected person is also not caught under the present person-connection approach (which requires the tracing of information back to the connected person). This needs to be remedied.”

⁵⁶⁴ MAS, *The Securities and Futures Act 2001 Consultation Document* (March 2001) at 27. The draft Securities and Futures Act 2001 s207(1)(a) defines an insider as any person who “possesses 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 securities”.

⁵⁶⁵ MAS, *Insider Trading: Consultation Document* (January 2001) Annexure 2 cl 12.3.6, 12.3.7.

On-market and off-market application of insider trading prohibition

The draft Singapore legislation adopts the Australian approach, namely to apply to off-market and on-market transactions except in one instance.⁵⁶⁶

Use of inside information

In *PP v Ng Chee Kheong* (1999),⁵⁶⁷ the Court ruled that the requisite mens rea included that the defendant intended to use the inside information, that is, that the information was the reason for, or a factor in, the decision to trade. In this regard, “the respondent’s reasons for making the trade must be tested objectively”.

The MAS has argued that the requirement to prove intent to use inside information makes it too onerous for the prosecution and reduces the effectiveness of the insider trading laws. The MAS proposes a statutory amendment to specifically exclude any use requirement.⁵⁶⁸

Regulator’s remedies

Subject to any criminal proceedings for insider trading, the MAS, under the proposed legislation, will have the power to seek a court order for a civil penalty of up to three times the amount of the profit gained or loss avoided through a contravention or a stipulated monetary amount, whichever is the greater.⁵⁶⁹ Where a person has been convicted or a civil penalty order has been made, the court may permit private claimants to file claims for compensation in respect of the contravention.⁵⁷⁰

Civil remedies

A private claimant may initiate civil proceedings for compensation⁵⁷¹ or may file a claim in response to an invitation by a court that has convicted a person of insider trading or has imposed a civil penalty order.⁵⁷²

Eligible claimants are persons who engaged in “contemporaneous” dealings at the time of the insider trading. The legislation does not define “contemporaneous dealing”. However, its intention is to cover investors who trade in the affected class of securities on the opposite side of the market to the insider at or about the same time as the insider, whether or not their orders are in fact matched with those of the insider.

⁵⁶⁶ Draft Securities and Futures Act 2001 s 202. The prohibition on communication of inside information by an insider to a third party only applies to exchange-tradeable financial products: s 207(3). The same principle applies in Australia: s 1002G(3).

⁵⁶⁷ [1999] 4 SLR 56.

⁵⁶⁸ MAS, *Insider Trading: Consultation Document* (January 2001), paras 6-8, 13. Under the draft Singapore Securities and Futures Act 2001 s 209(1), it is clear that, in any action against a person for breach of the insider trading provisions, it will not be necessary to prove, in addition to the other elements of the offence, that the defendant intended to use the relevant information.

⁵⁶⁹ Draft Securities and Futures Act 2001 s 221. A civil penalty action must be commenced within six years of the date of the contravention: s 221(1). Criminal proceedings take priority over civil penalty proceedings: s 222(2), (3).

⁵⁷⁰ *id.*, s 225.

⁵⁷¹ *id.*, s 223.

⁵⁷² *id.*, s 225.

The legislation sets out a number of factors that the court may take into account in determining whether contemporaneous dealing has taken place, namely:

- the volume of the relevant securities or other financial products traded between the date and time of the contravention and the date and time of the alleged contemporaneous trading
- the date and time of the contravention
- whether the alleged contemporaneous trading took place before or after the contravention
- whether the alleged contemporaneous trading took place before or after the information that relates to the inside dealing became generally known, and
- such other factors and developments, whether in Singapore or otherwise, as the court may consider relevant.⁵⁷³

One commentator has suggested that contemporaneous dealings should be confined to trades entered into on the same day as the insider dealing, whether before or after the time that the insider dealing took place.⁵⁷⁴

Determination and distribution of damages

Eligible civil claimants are entitled to compensation, assessed as the difference between the price at which the relevant securities or other financial products were dealt with in the contemporaneous trading and the price at which they would have been dealt with if the contravention had not occurred.⁵⁷⁵ However, these claims, in total, cannot exceed the “maximum recoverable amount”, being the profit that the contravening person gained or the loss avoided as a result of the contravention.⁵⁷⁶ Where the total civil claims exceed the maximum recoverable amount, a “first come first served” principle applies.⁵⁷⁷

⁵⁷³ id, s 223(4) (this reflects the current law: Securities Industry (Amendment) Act 2000 (Singapore) s 104C(4)).

⁵⁷⁴ Tan Cheng Han, “Protecting the integrity of the securities market: recent amendments to the law relating to insider trading” [2000] *Singapore Journal of Legal Studies* 33 at 46.

⁵⁷⁵ Draft Securities and Futures Act 2001 s 223(1).

⁵⁷⁶ id, s 223(5).

⁵⁷⁷ Ibid. Where the court invites persons to make civil claims, those persons are treated as making simultaneous civil claims. They may obtain compensation, which in total cannot exceed the maximum recoverable amount, reduced by any earlier private civil claims that take priority under the “first come first served” principle. Where the compensation claimed exceeds the (residual) maximum recoverable amount, that amount will be prorated among these claimants (s 225(3)).

Appendix 10

Malaysia

The Malaysian legislation was amended in 1998 to bring it more closely into line with the current Australian law.

Level of precision of inside information

The Malaysian legislation defines information more comprehensively than the Australian legislation. In addition to the matters coming within the Australian definition of information, the Malaysian legislation covers:

- matters relating to negotiations or proposals with respect to commercial dealings or dealings in securities
- information relating to the financial performance of the company
- matters relevant to the future of the company, and
- information that a person proposes to enter into a transaction with respect to securities.⁵⁷⁸

One commentator has pointed out that this approach, introduced in 1998, represents a complete departure from the previous “specific confidential information” requirement which proved susceptible to various interpretations, particularly in relation to whether a mere inference or deduction could be regarded as either specific or confidential in its nature.⁵⁷⁹

Who are insiders

The Malaysian legislation adopts an “information connection” only test and does not distinguish between primary and secondary insiders. An insider is any person who is knowingly aware of inside information, regardless of how that person obtained the information. No relationship needs to be established between the insider and the company whose securities are traded.⁵⁸⁰ Any person, including a bystander who overhears relevant inside information, can potentially be an insider.

⁵⁷⁸ Securities Industry Act 1983 s 89.

⁵⁷⁹ J Pascoe, “Insider Trading Law Reform In Malaysia: Lessons From Down Under” [2000] 2 *The Malayan Law Journal* xxxiii at xlvii.

⁵⁸⁰ Securities Industry Act 1983 s 89E.

Liabilities of insiders

Trading, disclosing and procuring

The Malaysian legislation adopts the principles in the current Australian insider trading laws.⁵⁸¹

Regulator's remedies

Insider trading constitutes a criminal offence. In addition, the Malaysian Securities Commission may take civil action against an insider to obtain one or both of the following remedies:

- recovery of an amount up to three times the difference between the price at which the securities were transacted and the price at which they would have been likely to have been transacted if the relevant confidential price-sensitive information had then been generally available, and
- a civil penalty up to a stipulated statutory financial limit.⁵⁸²

The Securities Commission may institute civil proceedings whether or not the offender has been charged with a criminal offence.⁵⁸³ Funds recovered are to be first applied to cover all investigative and enforcement costs of the Commission, with remaining funds being distributed to those market participants who transacted in the relevant securities at any time between the insider trading and the time when the confidential price-sensitive information became generally available.⁵⁸⁴

⁵⁸¹ id, s 89E(2), (3).

⁵⁸² id, s 90A.

⁵⁸³ id, s 90.

⁵⁸⁴ id, s 90A.

Appendix 11

Proposed European Union Directive

As indicated in Appendix 2, the Commission of the European Communities in May 2001 released a proposal for a new Directive on *Insider Dealing and Market Manipulation (Market Abuse)* (the proposed Directive). If implemented, this Directive would substitute for the 1989 EU Insider Trading Directive.

The proposed Directive, like the 1989 Directive, takes the view that persons who trade on inside information have an unjustified economic advantage over other market participants. Insider trading laws are necessary to enhance investor confidence in those markets.

The proposed Directive adopts the main principles in the 1989 Directive, including distinguishing between primary and secondary insiders and applying the insider trading laws to financial instruments that are traded or capable of being traded on a regulated market. The proposed Directive, however, differs from the 1989 Directive in some significant respects. It would:

- apply to all financial instruments, including derivatives over commodities, not just securities (draft Articles 2, 3 and Section A of the Annex). According to the Commentary on the proposed Directive, “the scope of financial instruments significantly affected by privileged information is not limited to those of the issuer but enlarged to related derivative financial instruments (eg options on equity, futures and options on index)”. This topic is discussed in paras 2.85-2.92 and Issue 12 of this Discussion Paper
- state expressly that the insider trading prohibitions should apply to “any natural or legal person” (draft Article 2). This topic is discussed in paras 1.48-1.56 and Issue 3 of this Discussion Paper
- in relation to primary insiders, exclude the requirement that they have “full knowledge of the facts” (draft Article 2). According to the Commentary on the proposed Directive, this requirement is repealed “as by nature [primary] insiders may have access to inside information on a daily basis and are aware of the confidential nature of the information that they receive”. This topic is discussed in paras 2.133-2.141 and Issues 18-19 of this Discussion Paper
- adopt an “information connection” definition of secondary insider (as under the current German law). A secondary insider would be any person, other than a primary insider, “who with full knowledge of the facts possesses inside information”. These secondary insiders would be subject to the same trading, disclosing and procuring prohibitions as primary insiders (draft Article 4). This topic is discussed in paras 1.57-1.74 and Issue 4 of this Discussion Paper

- require that issuers of financial instruments inform the public as soon as possible of inside information, subject to various confidentiality and other exemptions. There are related controls over selective disclosure (draft Article 6 paras 1-4). This topic is discussed in paras 2.62-2.67 and Issue 9 of this Discussion Paper
- require that any “natural person, or an entity, professionally arranging transactions in financial instruments shall refrain from entering into transactions, and reject orders on behalf of its clients, if it reasonably suspects that a transaction would be based on inside information” (draft Article 6 para 5). This topic is discussed in paras 2.183-2.189 and Issues 25-26 of this Discussion Paper
- exempt buy-backs, and market stabilisations during an initial or secondary public offer, from the insider trading provisions, provided they comply with such conditions as are prescribed by the Commission (draft Article 8). The Commentary to the proposed Directive states that: “Trading in own shares and stabilisation however must be carried out transparently in order to avoid insider dealing or giving misleading signals to the markets. Trading in own shares could be used to strengthen the equity capital of issuers and so would be in investors’ interest”. Relevant discussion is found in paras 2.99-2.106 and Issue 14 (new issues) and paras 2.107-2.116 Issue 15 (buy-backs) of this Discussion Paper.

The proposed Directive has various other draft Articles to assist in the prevention, detection, investigation and prosecution of insider trading and other market abuse in EU Member States.