Submission to the Corporations and Markets Advisory Committee

Insider Trading Proposals Paper

November 2002

1. Introduction

ANZ welcomes the opportunity to provide a submission to the Corporations and Markets Advisory Committee (CAMAC) in response to the *Insider Trading Proposals Paper* released in September 2002, as part of the review of Australia's insider trading laws.

As highlighted in the proposals paper, in March 2002 the Financial Services Reform Act (FSRA) introduced amendments into the Corporations Act, which included "extending the insider trading laws beyond securities (including a limited class of over-the-counter-traded financial products) and some futures contracts to a very broad range of financial products, including all derivatives".[1] The intention of the FSRA amendments was to harmonise the regulation of financial markets and services, so as to minimise both inefficiencies and costs resulting from regulation.

ANZ supports insider trading laws in principle, particularly in their role of ensuring that exchange markets work efficiently and fairly.

However, the capture of over-the-counter (OTC) traded financial products such as credit derivatives under insider trading laws has significant implications for the ability of financial institutions to manage risk. OTC traded financial products such as credit derivatives are one tool used for managing risk, which, while still in their infancy in Australia, are an accepted part of risk management strategy for banking institutions overseas in the United States and United Kingdom.

ANZ has participated in the Australian Financial Markets Association (AFMA) submission to CAMAC as part of the AFMA FSR Task Force and supports AFMA's recommendations to the Committee. Nevertheless, ANZ would like to provide the following comments on the implications of current insider trading laws for OTC traded financial products such as credit derivatives and the limitations this places on risk management strategies.

2. Risk management at ANZ

The identification and effective management of risk is an essential part of banking and a core competency of successful financial institutions. Effective risk management is essential to ensuring the stability of the financial system. ANZ has a comprehensive risk management framework comprising:

- The Board, which approves risk 'appetite' and strategy and monitors progress through the Risk Management Committee;
- The development and maintenance of Group-wide risk management policies, procedures and systems, overseen by an independent central team;

[1] CAMAC, *Insider Trading Proposals Paper, September 2002*, paragraph 0.4.

- The use of sophisticated risk tools, applications and processes to execute the global risk management strategy across the ANZ Group; and
- Business unit-level accountability for risk management.

As part of its day-to-day business ANZ needs to manage three broad risk categories:

1. Credit risk – the risk associated with the potential financial loss resulting from the failure of a party to honour fully the terms of a loan contract.

2. Market risk – the risk that the Group will incur losses from changes in interest rates, foreign exchange rates or the prices of equity shares and indices, commodities, debt securities and other financial contracts including derivatives.

3. Operating risk – the risk of direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events.

3. Credit derivatives

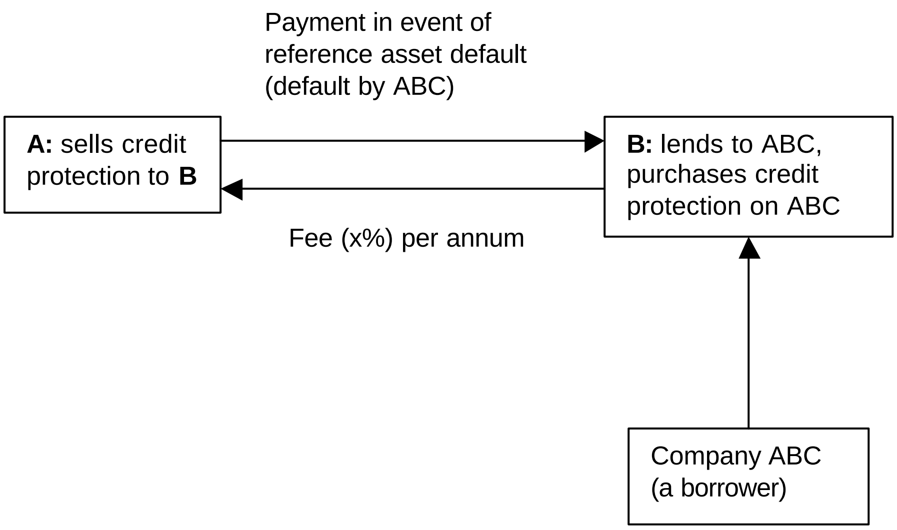
As highlighted in the proposals paper, a key role of OTC markets is to allow the trade in products designed for the transfer of financial, commercial or production risks. Financial institutions use OTC markets to transfer risk through credit derivative contracts such as credit default swaps.

Credit default swaps are instruments designed to transfer the risk of an asset (for example, a loan on a bank's portfolio from the Protection Buyer, that is the lending bank, to the Protection Seller) without transferring the legal ownership of that asset. In Figure 1 the Protection Buyer (B) pays the Protection Seller (A) either a periodic or an up-front fee in exchange for protection against a possible loss suffered if a 'credit event' occurs, such as bankruptcy of the reference entity (company ABC) or the reference entity defaulting on its credit obligation. The protection lasts until the termination date of the protection contract or on the occurrence of a credit event.

The parties to the credit default swap – the protection buyer and the protection seller – are typically highly sophisticated domestic or international financial institutions. While there is no prohibition on less sophisticated parties participating in OTC markets such as these, their participation is highly improbable. Most of these transactions involve credit protection on multi-million dollar assets. The price of the protection is negotiated under contract between the two parties, where the terms and conditions of the contract outline the level of disclosure required.

For a bank such as ANZ, credit derivatives potentially could be used for obtaining or managing exposure on the trading book or managing credit risk on the loan portfolio book.

Figure 1: Credit default swap



4. Is there a need to regulate OTC-traded financial products such as credit derivatives?

Under the current insider trading laws it is possible for financial institutions to use OTC transactions such as credit derivatives to manage the trading book, provided that strict Chinese Wall arrangements are in place where the corporate banking arm of an institution holds price sensitive information about a reference entity. ANZ has well defined Chinese Wall arrangements and protocols in place to ensure that ANZ's trading desks within the Capital Markets and Foreign Exchange Divisions are capable of operating within the current legislation.

In contrast, it is difficult for the corporate bank to use credit derivatives to manage credit risk on a financial institution's loan portfolio under current insider trading laws. ANZ has a Portfolio Management function managing credit risk on ANZ's loan portfolio, which is effectively subject to Chinese Wall arrangements. However these types of arrangements are not optimal in that they act contrary to best practice risk management. Best practice risk management should involve utilising all sources of available information, both publicly available and available through the client relationship, in managing exposures on the banking book. The current legislation requires information that is typically sourced from clients to be withheld from the process of managing loan portfolio risk.

The key rationale for prohibiting insider trading is that regulation is needed to ensure that markets operate efficiently. Insider trading regulation aims to overcome the market inefficiencies which arise from asymmetries in the information held by two parties to a transaction.

In transactions on an exchange such as the ASX insider trading regulation is necessary. Retail participants are essentially price takers and are not in a position to protect themselves from risks arising from information asymmetries through tailoring contractual terms or prices.

As explained above and in the proposals paper, OTC transactions can be tailored through bilateral negotiation. The parties to the transaction are in a position to protect themselves through specifying the level of disclosure in the terms of the contract and through incorporating any risks of information asymmetry into the price. And as further highlighted in the proposals paper these parties can then rely on statutory and common law protections against misrepresentation or false and misleading statements.

The decision to regulate must take into account whether the inefficiencies that arise from the market failure, in this case information asymmetry, are already addressed by the market and if not, whether the benefits of regulating to address the market failure outweigh any regulatory costs borne by the market. In the case of OTC transactions such as credit derivatives, it is clear that the market through the contractual terms and conditions negotiated between the parties addresses any information asymmetries arising in the transaction. Hence, regulation to overcome information asymmetries in OTC transactions is unnecessary and would also impose an unnecessary restriction on financial institutions' ability to use these tools as part of managing their credit risk.

5. Breach of a Chinese Wall

If the insider trading laws remain as they stand, financial institutions are more heavily reliant on the effectiveness of Chinese Wall arrangements to ensure compliance with the current regime. However, the extension of the insider trading regime from securities (as defined pre-FSR amendments) to a substantially greater number of financial products also increases the possibility that a Chinese Wall may be breached inadvertently.

For example, a person possessing inside information may not deal in *relevant Division 3 financial products,* but procure another person to deal, or communicate the information to another person who would be likely to deal or would be likely to procure another person to deal, in the *relevant Division 3 financial products.* In these circumstances, it is an offence to trade in the particular product until the inside information ceases to be inside information. In some cases, this may not occur for some time or may not occur at all.

If a Chinese Wall were breached inadvertently by an organisation trading in financial products such as OTC traded financial products, the organisation has no ability to 'repair' the breach. Instead, at the very least the organisation must not deal in the particular product and possibly not deal in products of that class or type. This could have serious consequences for the risk management practices of the organisation and also for clients of the organisation.

ANZ recognises the sound policy behind ensuring that Chinese Walls are robust. Organisations should have strong incentives to ensure that their Chinese Walls remain intact. However, in cases of an inadvertent breach ANZ proposes there should be a means to 'repair' the Chinese Wall. One option for repair could involve reporting the breach to the market operator in the case of products that can be traded on a financial market or by reporting the breach to ASIC in all other cases. Dealing in that product or products of that class could then occur on the terms set down by the market operator or ASIC.

6. Recommendation

OTC traded financial products such as credit derivatives are an accepted risk management tool for banking institutions around the world. The capture of OTC traded financial products such as credit derivatives under Australian insider trading laws has significant implications for the ability of financial institutions in this country to manage risk.

It is ANZ's view that current insider trading laws as they apply to OTC transactions such as credit derivatives are unnecessarily restrictive. As the law currently stands, financial institutions are not in a position to use these tools for managing credit risk and there does not appear to be a sound economic rationale for this restriction.

Ideally, it would be preferable if insider trading laws as they apply to OTC traded financial products were repealed but we recognise the practical difficulties involved in changing the legislation at this stage. However, as a second best solution ANZ would support the exemption from insider trading laws of OTC transactions where the reference entity is a publicly listed company. In these instances, the reference entity would be subject to the continuous disclosure rules of the ASX and would be publicly rated by a third party rating agency.

If the insider trading laws remain as they stand, ANZ considers that there should be a means to 'repair' a Chinese Wall in the case of inadvertent breach such as reporting the breach by reporting the breach to ASIC for products that cannot be traded on a financial market.

AFMA RESPONSE to the CAMAC INSIDER TRADING PROPOSAL PAPER

1.0 Introduction

The Australian Financial Markets Association (AFMA) commends the Corporations and Market Advisory Committee (CAMAC) on their insider trading Proposals Paper, September 2002. The following sub-committees of AFMA have considered the Paper in detail:

· AFMA FSR Task Force
· AFMA Electricity & Energy Committee

(The membership of these subcommittees is attached for your perusal.)

Both sub-committees agree that the Paper represents a quantum step forward in the longstanding analysis of the issues surrounding the Australian insider trading rules. The AFMA Energy & Electricity Committee have forwarded comments directly to CAMAC.

The potential issues relating to insider trading have been significantly increased by the Financial Services Reform legislation. Overall, AFMA is of the view that the outcome of this legislation has been greater uncertainty, less harmonisation with international markets, and potentially significant compliance cost that will be borne by the end-user.

The FSR insider trading laws have increased the internal costs to the provision of financial services. These costs will be initially borne by providers of financial services and then by the consumer. The public will also bear direct costs, as the laws apply to all persons, and are not restricted to licensees. AFMA have conservatively estimated the additional costs to our Members of $460 million per year for the wider FSR insider trading laws. The AFMA estimate does not factor the increased public information disclosure systems for all Division 3 financial products, or any costs of lost opportunities in international financial services.These costs will be reflected in a decline in services and products offered to customers, particularly retail clients.

The increased costs are directly related to the wider scope of transactions. Insider trading now encompasses nearly all financial transactions whether or not they are traded on a licensed market. That means that approximately $50,000 billion new transactions per year have been caught in a regime that formerly designed to cover only $400 billion. The benefit of legislative change is “harmonisation” of treatment between financial products which (it is contended) will (in all cases) lead to an increase in efficiency and fairness of the “financial market”. While the costs will definitely be realised, AFMA is firmly of the view that the benefits will not be realised for transactions other than those traded on a licensed market with a market-based continuous disclosure regime.

The Members of AFMA transact in OTC financial products, privately and bilaterally negotiated between sophisticated participants, and on the Australian and offshore licensed markets. Accordingly while the main issue of AFMA is the impact of the FSR insider trading laws on OTC financial transactions, our members are also concerned with the interactions between OTC financial transactions and transactions undertaken on licensed markets. Accordingly, AFMA has considered the insider trading laws from a perspective of a whole-ofbusiness or whole-of industry approach.

2.0 Chapter 1: Financial Markets Transactions

2.1 Competitive neutrality and harmonization

The objectives of the FSR insider trading amendments were **competitive neutrality** and **harmonisation**.

AFMA strongly agree with section 1.8 of the Paper. Insufficient account was taken of the essential differences between the different markets and transactions defined as Division 3 Financial Products.

While internal harmonisation was the objective of the insider trading amendments, it is arguable that Part 7.10 is inconsistent with the other Parts of the FSR act, and contains internal inconsistencies that prejudice compliance with the provisions.

Division 2 and Division 3 of Part 7.10 of the Corporations Act lack consistency. Division market efficiency offences pertain to all financial products but is essentially restricted to licensed financial markets. However, Division 3 applies to a specified range of financial products whether or not they are traded on a licensed financial market. This difference creates uncertainty, and AFMA suggests that it is not consistent with the stated purpose of the FSR Act.

AFMA propose that Division 3 should apply to the same range of financial products/markets as Division 2. Such a simple change is consistent with the proposals in the CAMAC Proposals Paper (s.1.68 Dot three).

Further, ensuring that Part 7.10 is consistent (or harmonised) with the remainder of the FSR provisions would also assist with public understanding of Part 7.10, without avoiding the regulatory intent, through:

1. Adding regulation making powers;
2. Adding exemption and modification powers for ASIC; and,
3. Promoting consumer protection through adopting an abuse of information test (similar to that adopted by the FSA).

2.2 Risk transfer of OTC financial markets

AFMA agrees strongly with sections 1.53 and 1.57. OTC transactions are often used to manage financial risk arising in the ordinary course of business. Parties agree to transfer and accept risk in return for a premium. Participants accept that OTC transactions may have unequal levels of information about the risks or benefits associated with that OTC transaction. The level of inequality is reflected in the calculation of the premium.

Parties to OTC transactions who are concerned about the unequal level of information may ensure that their contract includes terms that ensure material, price sensitive information is disclosed. Inclusion of these terms is known as ‘bilateral disclosure management’ and is a feature of OTC financial markets. OTC financial markets, in this regard, are different from other financial markets because they involve principal-to-principal participants contracting with each other directly and non-anonymously. In other financial markets, standardized contract terms and the anonymity of trading through a broker do not allow for bilateral disclosure management. Accordingly, the requirement for insider trading laws is higher in licensed financial markets.

Participants can and do protect themselves bilaterally, but can also access other contracting remedies and market conduct offences because of their direct relationship with their counterpart. The offences of false and misleading statements, and dishonest conduct (particularly dishonest concealment) appear to be more focused on consumer protection than the concept of “market efficiency”.

In addition to disclosure management, a very real self-regulating mechanism in the OTC markets is that participants have reputations to maintain and protect. A participant who acts in a way which the market deems inappropriate carries the risk that the rest of the market will refuse to deal with them in the future. This has been called “peer suasion”.

AFMA also believes that applying insider trading laws to OTC financial markets will not increase “market efficiency”. While the term ‘financial market’ is often used to describe OTC transactions this is a legal concept not an economic one. In reality, no OTC financial market exists. Every contract is materially different, each contract involves only one buyer and one seller, and there is no mechanism that allows third parties to make or accept offers to buy or sell. Therefore, there is no ‘financial market’ in the economic sense that may be made more efficient. There is no evidence that the introduction of the FSR insider trading provisions have, in any way, increased “market efficiency” or “fairness”. On the contrary AFMA would contend that there is some evidence that the laws have, and will continue, to reduce the efficiency of trading in OTC financial products through higher transaction costs, wider spreads, reduced liquidity, and reduced participation.

2.3 Insider trading laws prior to March 2002 (relating to OTC financial transactions)

AFMA agrees strongly with sections 1.60 – 1.63. The insider trading laws previously did not materially apply to OTC transactions. There are strong arguments that suggest that arrangement should have continued.

The requirement to apply insider trading laws to OTC transactions was never publicly debated in the FSR Act consultation. The Explanatory Memorandum to the FSR Act conceded that Treasury did not receive a single submission on this contentious amendment to the law. We are strongly of the view that most if not all, private sector stakeholders misunderstood the intentions of the legislators.

Whether, and to what extent, insider trading laws are required for OTC transaction efficiency or fairness has never been progressed past a statement of optimising harmonisation. The regulatory cost and benefit analysis was never undertaken. It now appears that the insider trading laws are not in harmony with the other sections of the Corporations Act, and that the costs to the public for this harmonisation are greater than the potential savings and benefits.

However, the arguments that support the maintenance of the old-law status quo would also suggest that the insider trading laws prior to 11 March 2002 was defective in that they included unlisted securities such as corporate bonds.

2.4 Impact on Australia as a centre for financial services

AFMA agree strongly with section 1.65. FSR insider trading laws are not replicated elsewhere in the world and it is unlikely that they ever will be replicated in any other financial centre jurisdiction. The UK FSA have recently reviewed their rules and decided on an approach focussing on listed products and licensed markets – precisely what was expected by Australian industry in the FSR Act.

As such, FSR insider trading laws are out of step with world best practice. Consequently, the financial services industry and public operating in Australia are at a distinct disadvantage when compared to those operating in other financial centres.

Financial services is a highly globalised industry dominated by trans-national organizations who locate their management and resources around the world for optimal effect. In practice, these organisations gravitate towards financial centres that strike the balance of rules and freedoms. Whilst it may be tempting to develop rules that seek the moral high ground, an inappropriate balance will result in fewer financial services participants, and the costs being borne by the end users of the products.

2.5 Market Arbitrage

CAMAC states in 1.72 that "… market arbitrage may not of itself justify insider trading laws on all OTC transactions …". AFMA believes that market arbitrage does not in itself justify insider trading laws on **any** OTC transactions (except where an OTC transaction is directly and materially linked to a licensed market transaction. For example, the same product trading on a licensed market and OTC).

AFMA supports this proposal while there is a strong nexus between the transactions such as the same share (or stapling of shares) traded both on a licensed market and OTC; or perhaps an OTC derivative that exactly replicates an on-exchange transaction in all economic respects. AFMA does not support this proposal to the degree that certain FSR products or FSR product classes could be generally "deemed" to be linked. For example, the fact that electricity derivatives may be traded on a licensed derivatives market and OTC would not in itself be sufficient justification to link those transactions. Finally, AFMA is unaware of any "market arbitrage" between OTC transactions and licensed markets in Australia.

If "market arbitrage" were to exist in Australia, and if it were avoidable by harmonizing Australian insider trading laws, it is not avoidable globally. Many of the OTC transactions that have recently become the subject of regulatory harmonisation under FSR are traded outside this jurisdiction, and could be "market arbitraged" in those financial centres or markets. If a person wished to avoid use "market arbitrage" they would simply choose to undertake their transaction in any other jurisdiction – not another market within this jurisdiction. Regulatory harmonisation with an objective of combating "market arbitrage", to the extent that activity may exist, is an incomplete solution and one that highlights the differences between the Australian insider trading rules and those of the rest of the world.

2.6 Misuse Requirement

AFMA support the application of a misuse requirement. (Paras 4.23 – 4.28 of the Paper) Removing the intent fault provisions and extending the insider trading rules has meant that AFMA response to CAMAC insider trading Proposal Paper the risk of "rogue" or "unsolicited" inside information is a major risk for OTC participants. Such information could prevent licensees from undertaking legitimate hedging activities or transactions committed to prior to the information, and would not reasonably be protected by the current "Chinese wall" defence.

AFMA propose a defence along the lines of the UK FSA prescription, viz "… if dealing was required … to comply with a legal (including contractual) … or regulatory obligation that existed before the relevant information was in that person's possession".

3.0 OTC Financial Markets Policy Options (section 1.68)

The Policy Options for OTC financial markets are outlined in section 1.68 and following sections of the Paper. Although the options outlined are presented as mutually exclusive, they do not appear to be so as it would be possible to include elements of two or three options. For example, notwithstanding any future changes to the substantive law, to remove the uncertainty that exists now because of their application, the laws must be repealed from 11 March 2002 to the date of any change in the substantive law. Otherwise, market participants will be subjected to the ongoing possibility of civil action for breaches of the insider trading laws occurring during that period (even if the regulator were to choose not to exercise their regulatory mandate).

Each of the options is considered below.

3.1 That current insider trading laws remain unchanged (not considered in detail in the Paper).

This is not a viable option for the Australian market to continue to operate on an equal footing with competing international jurisdictions. There is no sustainable case for retaining the current laws in their current form. If the laws remain unchanged, AFMA believes that the uncertainty of their application will promote criminal, civil-penalty, and civil proceedings, despite the activities of Australian OTC participants being consistent with internationally accepted standards.

3.2 That current insider trading laws be repealed (1.69 – 1.73)

The Members of AFMA would unanimously support a full repeal of the FSR insider trading laws, backdated until 11 March 2002. Backdating any repeal is required to protect the public against prosecution or litigation in the period from 11 March until any new law becomes effective.

Repealing the insider trading laws would allow a return to the status quo prior to the FSR Act – principally listed products on licensed exchanges with a centralised disclosure system operated centrally by the exchange.

However, as noted above at 2.4, AFMA's view is that the original law was defective in as much as it applied to unlisted securities such as corporate bonds. We would therefore support the further amendment of the pre-11 March 2002 laws to exclude securities not listed on a licensed financial market.

AFMA would also support the repeal of the "financial services civil penalty provision(s)" – particularly those relating to the insider trading laws – s.1317E(1)(jf&g), while retaining the criminal penalty provisions. The operation of the civil offence provisions is a major source of confusion and uncertainty to AFMA members. Certainly the minds of our members would be eased considerably if s.1317J(2) were repealed (along with any other sections relating to the ability for any corporation to apply to the court for a civil penalty).

At the current time Australia is out of step with international regulatory trends in market conduct rules. The legislators embarked upon a course during the CLERP 6 consultations that anticipated other international regulators would amend their insider trading rules. Whilst this has occurred the Australian Laws have diverged from internationally accepted principles. This is the proper time for Australia to recognise that the direction enunciated in the CLERP 6 papers requires alignment with other major financial centres and that our current laws sets us apart from world best practice.

3.3 That current insider trading laws be limited to "linked" products (1.74 – 1.77)

The proposal that insider trading is limited to linked products is the second most preferred outcome by AFMA when combined with the disclosable information proposal below. We restate that in AFMA's view there is no clear policy objective that supports the extension of the insider trading laws to OTC products. Extension of the laws has imposed additional costs to an efficient, cost-conscious and dynamic part of the financial services sector, where consumer protection has not been identified as a requirement by any analysis.

AFMA acknowledges two possible arguments in support of this proposal. First, subject to including the concept of "disclosable information" (below), limiting insider trading to linked products would place the Australian regulatory system much closer to world best practice, for example the UK FSA model.

Second, limiting insider trading to linked products would bring the insider trading laws much closer to the other market efficiency measures in Part 7.10, Division 2, namely market manipulation, false trading, and market rigging which would have the benefit of uniformity. The reasons for the internal differences in part 7.10 are unclear and create unintended confusion in the public.

Alternatively, AFMA is aware of three criticisms that detract from this proposal. First, the proposal rests heavily on the law and policy relating to what is a licensed market: in particular, the precise delineation between licensed financial markets and other 'financial markets'. This is by no means clear, and is subject to policy-based interpretation by ASIC. In any case the legal definition of markets has diverged from the common understanding and the economic definition of markets used as the basis of the "efficiency" argument.

Second, there is concern over how to define the link between products traded on and off licensed markets (refer para 2.6 above). AFMA believes that this issue is addressed by the position put forward in section 1.74: applying the insider trading laws to OTC products that are able to be traded on an exchange or other licensed financial market. The aim of avoiding market arbitrage, while providing certainty of coverage in the application of the law would be satisfied by this test.

Third, there is a criticism that listing the product on the licensed market could link OTC products to licensed markets simply and artificially. The concern is that an illiquid and immaterial market listing could control a vast number of OTC transactions indirectly via the "linking"; in essence the "tail wagging the dog". There are a number of real examples of this at the current time – electricity futures and OTC electricity swaps, corporate bonds listed on the ASX and traded OTC, FX warrants traded on the ASX and OTC. AFMA proposes that the linking rule be related to a materiality test similar to that used in ASIC Policy Statement 172 regarding the licensing requirements of markets that have immaterial turnover. AFMA propose that the burden of proof is placed on the complainant or prosecutor shows that there was a direct and material link between the off- and on-market transactions.

3.4 That the current insider trading laws be limited to disclosable information (1.78 – 1.81)

The proposal that insider information be limited to disclosable information only is the third most preferred outcome by AFMA. By itself we do not consider this a workable option. AFMA suggests that this option should be considered in conjunction with the product linking test above. Combining a limitation of “disclosable information” with limiting insider trading to closely linked products (above) would place the Australian regulatory system much closer to world best practice, for example the UK FSA model.

AFMA submits that the concept of ‘disclosable information’ described in paras 1.21 to 1.25 would be useful to providing some clarity in what amounts to ‘inside information’. In coming to that conclusion, AFMA assumes that CAMAC is sympathetic of the FSA formulation that defines disclosable information in terms of:

1. continuous disclosure (or other mandatory public exchange disclosure);
2. disclosure required by law (such as electricity generator capacities); and
3. information that is routinely the subject of public announcement.

These categories are largely discrete and independently verifiable from public sources. Information and the time that information was made available will be independently verifiable and minimise definitional issues that currently reduce clarity in application of insider trading laws.

By closely linking OTC products caught by the provisions and application of this disclosable information test, the problems identified by CAMAC in para 1.80 of their paper could be minimised. ‘Inside information’ in relation to OTC products would be rare and generally would arise because the information relates to an underlying financial product that is exchange traded on an exchange with mandatory public announcement procedures.

AFMA are pleased that CAMAC acknowledge in section 1.66 that the current definition of inside information, while appropriate for Australia’s listed securities markets, is unreasonable for other transactions considering the varying disclosure expectations of participants and the public.

Subject to well defined ‘Chinese wall’ defences being available, limiting the insider trading laws to disclosable information would address the difficult issue for many of our Members relating to corporate information collected in part of their business that is separate from their trading business. Many of AFMA’s Members collect information as part of their non-trading operations, which require them to enter into transactions to manage their financial risk. Currently, the “own intentions” defence may not protect our members and so their risk management policies may be frustrated by an inability to trade – for example by an inability to trade credit derivatives that hedge risk exposure arising because of lending activities. It is imperative that this issue is corrected, otherwise, the scope of financial services provided will be limited.

AFMA recognise that the proposed test above is flexible enough to accommodate all financial products and markets, not simply OTC transactions. Accordingly, CAMAC's proposal regarding disclosable information in this format, using the concept of linked transactions, should meet with acceptance, as it is a test that may be a solution to all financial market environments.

4.0 AFMA's preferred position regarding the position paper options

The Australian Financial Markets Association believes that insider trading offences should only apply to listed products on licensed financial markets. This is consistent with the public understanding of the offence, and serves to protect the retail consumers whose access to financial markets is generally through licensed markets.

Our preferred position is to repeal the insider trading laws to the situation prior to the FSR Act, and to backdate that repeal to 11 March 2002. Further, to provide consistency, AFMA would recommend the pre-11 March 2002 laws are amended to exclude securities not listed on a licensed financial market. This would draw the Australian insider trading laws closer to world's best practice.

AFMA propose that the government repeal the civil offence penalty provisions relating to insider trading as they have been the source of significant alarm to financial services licensees, the staff of licensees, and the public. The criminal penalty provisions and the application of the Commonwealth Crimes Code need clarification, but should be retained. The Part 7.10 market efficiency-directed offences should be criminal offences first and foremost.

It is possible that Treasury will find repealing the insider trading law unacceptable. In this case AFMA suggest the appropriate mix of limiting inside information to disclosable information and applying the insider trading provisions to products listed on a licensed market or other transactions that can be shown to have a direct and material link (at the time of the offence) to a product listed on a licensed market. This outcome would closely replicate international best practice, such as UK FSA.

5.0 Conclusions.

The current insider trading laws are unacceptable, uncertain, unfair and unworkable.

After extensive consultation and analysis, the Members of AFMA believe that a major part of their business will be subject to continuing uncertainty that will limit financial services activity in Australia.

The Australian Financial Markets Association commends the CAMAC insider trading Proposal Paper. AFMA would like to reinforce that the solutions to the insider trading issues must be implemented quickly. AFMA encourage CAMAC to strongly promote that early amendments are critical to protect the Australian financial services industry and the public.

We trust that that CAMAC recommendations find acceptance with government and that the public and the financial services participants are signalled clearly before the first anniversary of the law – 11 March 2003. The Australian Financial Markets Association believes that the case has been made for an immediate return to the pre-FSR formulation of the insider trading laws, with the additional carve-out of securities not listed on a licensed financial market.

Attachment: FSR Task Force Committee Members

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25 October 2002

Mr John Kluver
Executive Director
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Dear John

“Insider Trading Proposals Paper” - September 2002

The Australian Financial Markets Association (AFMA) Electricity and Energy Committee welcomes the opportunity to comment on this Paper. AFMA’s Electricity and Energy Committee, comprising a representative cross-section of marketparticipants including retailers, generators, intermediaries and brokers, has considered the various proposals.

The Committee has come strongly to the view that the current insider trading laws should be repealed for all electricity products – trading on exchange or OTC.

Many of the reasons resulting in this view have been previously presented to CAMAC by representatives of AFMA and are well summarised in the Paper. In particular, the Committee noted the point made in s1.53 which accepted that “... a party to an OTC risk transfer contract may have information that could materially affect the value of that contract and which is unknown to the counterparty or to the market generally.”On that aspect alone, the current insider trading laws would be unworkable for OTC electricity and energy transactions.

In relation to exchange traded products, the Committee concluded that the insider trading laws for, what amount to, identical transactions on the SFE should be limited to products that were regulated under the pre-March 2002 legislation. The Paper is silent as to the electricity futures conducted by ASX and the Committee believes that they should also be exempted.

In both the OTC and on-exchange cases, the Committee determined that, should its preferred position not be adopted, the fallback position of incorporating the disclosable information element, should prevail. The Committee noted that this was a significantly less efficient and appropriate outcome but would be willing to assist in the development of appropriate disclosable information.

The Committee noted that the question of insider trading related to the efficient and fair functioning of financial markets; it is not, and should not be, directed at market power or manipulation which are properly outlawed through other, more appropriate, Acts (eg TPA), and other sections of the Corporations Law (eg, market manipulation).

Should you wish to discuss any of the above in more detail please feel free to contact either of the undersigned.

Yours sincerely

Kenton G Farrow	Darryl Flukes
Chief Executive	Chairperson

OVERVIEW

The Australian Institute of Company Directors (AICD) commends the Advisory Committee for compiling the *Insider Trading Proposals Paper* in the light of submissions made on the Advisory Committee's 2001 *Discussion Paper* and of the enactment with effect from March 2002 of the *Financial Services Reform Act* 2001 (FSRA). In particular, AICD commends the more extended discussion in the Proposals Paper of the application of the insider trading laws to financial products other than securities and to markets other than ASX and of the disclosable information element.

However, the AICD notes that the Advisory Committee has not addressed the arguments adduced by AICD for restoration of the "person connection" test in determining who is an "insider" to explain how, in a supposedly free market society, it is fair to make it unlawful for people who, through their own skill and effort unaided by any "connection" to the relevant company, lawfully acquire information that is not generally available, to turn that information to their advantage. AICD considers this question to be fundamental to the scope and operation of fair and workable legislation.

AICD's detailed submissions on the Proposal Paper follow.

1 CHAPTER 1 - FINANCIAL MARKET TRANSACTIONS

1.1 Disclosable information element

The Proposals Paper (para 1.22) puts forward for consideration the proposal that:

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

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

AICD believes that the Proposals Paper (paras 1.28-1.39) makes a strong case for making that change to Australia's insider trading legislation. In particular, adoption of the disclosable information element would significantly reduce the operation of the insider trading legislation in ways that are anomalous, illogical or unfair.

AICD also submits that if the disclosable information element is to be introduced:

- it should be an element of the offence and not merely a defence; and
- because of the inherent uncertainty of its operation, it would not of itself justify removal of the *readily observable matter* test of when *information is generally available*.

As the Advisory Committee pointed out in its introduction to the 2001 Discussion Paper, "*in almost every respect the Australian insider trading laws are stronger in their terms than comparable overseas laws*". That is true to the extent that the use in the legislation of the labels *insider, inside information* and *insider trading* cannot unfairly be characterized as misleading and deceptive.[1]

1.2 Application of insider trading laws to markets other than ASX

Like the Advisory Committee, AICD strongly supported the view expressed in the *Financial System Inquiry Final Report* that laws should not advantage one market over another, or discriminate between markets, except where there is an overriding public interest. The AICD also agrees with the point made in para 1.8 of the Proposals Paper that, in harmonizing the regulation of different financial markets with similar economic functions, account must also be taken of the essential differences between those markets.

In that light, AICD's views on the matters raised in the Proposals Paper in relation to markets other than ASX are:

(a) *SFE*

The Proposals Paper raised for consideration whether the present insider trading laws for SFE-traded should:

- remain unchanged;
- be limited to those products regulated under the pre-2002 legislation;

[1] The AICD suggests replacing *Insider Trading* as the title to CA Pt 7.10 Div. 3 with *Financial Products Trading Information Communication.*

- be limited by including the disclosable information element; or
- be limited in some other way.

The Proposals Paper discusses only the second and third policy options. The considerations put forward by the Advisory Committee in that discussion lead the AICD to support both the second and third policy options.

(b) *OTC Financial Markets*

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

- remain unchanged;
- be repealed;
- be limited to "*linked*" products;
- be limited to disclosable information; or
- be changed in some other manner.

The Advisory Committee discussed the merits of only the second, third and fourth of those options. The considerations put forward by the Advisory Committee in that discussion lead the AICD to support the second option, and exempting all OTC transactions from the insider trading laws.

(c) *Exempt Markets*

As the Advisory Committee points out, each exempt market has been established by a separate market declaration and has its own rules, including disclosure requirements. The AICD therefore agrees that the application of the insider trading laws to particular exempt markets would depend on the general policy approach to regulating markets and the characteristics of each exempt market.

(d) *Emerging Markets*

The AICD agrees with paras 1.85 and 1.86 of the Proposals Paper.

2 CHAPTER 2 - *POSSIBLE CARVE-OUTS*

2.1 Entity making a general issue

AICD submits that the rationale for excluding issuers from the insider trading regime as set out in para 2.7 of the Proposals Paper is more persuasive than that for including issuers in the insider trading regime as set in para 2.6.

AICD would also add the consideration that the policy underlying the introduction of CA Part 6D.3 by the *Corporate Law Economic Reform Program Act* 1999 was to confine the potential liability of an issuer under a Chapter 6D disclosure document to the range of criminal and civil liabilities in Part 6D.3, and to exclude other potential liability, for example, under TPA s52 or CA s1041E-1041H.

AICD notes that the Advisory Committee (Proposals Paper para 2.9) considers that offerees who subscribe for new issues when aware of inside information not known to the issuer should remain subject to the insider trading regime.

The issue is probably academic, in that it is difficult to imagine circumstances in which it would come to light that an offeree was in possession of price-sensitive unpublished information when subscribing under a prospectus offer.

The issue, however, raises a paradox. An offeree in possession of price-sensitive unpublished information who subscribes contravenes the insider trading laws, even if the subscription would have taken place had the offeree not been in possession of that information. On the other hand, if possession of that information leads the offeree **not** to subscribe, no offence is committed. Yet, in moral terms, the latter seems as reprehensible (or otherwise) as the former.

The issue is relevant to the discussion in the Proposals Paper (paras 4.23-4.28) on whether a ‘use’ requirement should be added as an element of the insider trading offence. It is also applicable to the issues raised by the Advisory Committee on placements and buy-backs.

2.2 Entity making an individual placement

Here again, AICD submits that the arguments for excluding issuers from the insider trading regime as set out in para 2.14-2.16 of the Proposals Paper outweigh those for including issuers, as set out in para 2.17 of the Proposals Paper.

In addition, the due diligence defences afforded by CA Part 6D.3 are applicable only to potential liability in respect of a Ch 6D disclosure document lodged with ASIC. An issuer making an exempt placement faces potential civil liability for misleading or deceptive conduct under CA s1041H, in respect of which there is no due diligence defence, as well as potential criminal liability under CA ss1041E-1041G.

2.3 Buy Backs

In considering the application of the insider trading laws to buy-backs, AICD notes that, although the table of *Other provisions relevant to buy-backs* in CA s257J includes the continuous disclosure provisions in Chapter 6CA, it does not include a reference to the insider trading provisions. There is fairly strong inference to be drawn from the omission that the Parliament did not intend buy-backs to be subject to the insider trading provisions.

Be that as it may, AICD is more persuaded by the argument for excluding buy-back entities from the insider trading regime set out in para 2.24 than by those for including them as set out in para 2.25.

AICD makes the additional points:

- having regard to the imputed possession by a body corporate of information possessed by any of its officers under CA s1042G, it would be practically impossible for a buy-back entity to know on a day-by-day basis - as a buy-back would require - whether or not it is an insider; and
- the inclusion of a buy-back entity in the insider trading regime would lead to unequal treatment as between those of its shareholders who are able to accept the buy-back offer before the entity became an insider, and those who are deprived of the opportunity to accept the offer after the entity becomes aware that it is an insider.

The latter two considerations are applicable also to entities making general issues and exempt placements.

2.4 Private transactions in exchange-tradeable financial products

AICD makes the following two points on this matter:

- non-disclosure of unpublished price-sensitive information by a party to a private transaction would probably amount to misleading or deceptive conduct within the meaning of s1041H, leading potentially, to strict civil liability; and

- in principle, there is a qualitative difference between a private transaction involving, on the other hand a person with "privileged" access to information- directors and other persons connected, who are *real* insiders - and, on the other hand, others who are *notional* insiders by virtue only the possession of information acquired without "privileged" access.

To exclude from the insider trading regime only *notional* insiders would, to that extent, bring Australia's laws more into line with those of overseas jurisdictions which, in the view of AICD, would be a step in the right direction for Australia.

If, however, the policy decision were made to include all or any private transactions in the insider trading regime, AICD would support the addition of the disclosable information element.

2.5 Transactions under non-discretionary trading plans

The Advisory Committee rightly draws attention to "the lack of flexibility under current Australian law", which prevents directors and other persons involved in management to sell their company's shares under a trading plan lawfully entered into in good faith.

In its submission on the Discussion Paper, AICD advocated the introduction of a rule similar to SEC Rule 10b5-1 along the lines set out in paras 2.41-2.43 of the Proposals Paper, and AICD remains of that view. Additionally, there would not appear to be any policy reasons against introduction of such a rule. None are indicated in the Proposals Paper.

2.6 Transactions in unlisted entities

AICD supports the policy option of excluding from the insider trading laws all transactions in the securities or other financial products of all unlisted entities.

First, to do so would overcome the anomaly, identified in para 2.47 of the Proposals Paper, that a sale of the shares in an unlisted entity attracts the insider trading laws, but a sale of its assets does not, except to the extent that the assets include Div. 3 financial products.

Secondly, parties to a transaction in unlisted financial products are, as is pointed out in more than one place in the Proposals Paper, free to choose a mutually-agreed level of disclosure.

Thirdly, the parties to a transaction involving unlisted financial products remain subject to the prohibition against misleading or deceptive conduct in CA s1041H which, as noted earlier, imposes strict civil liability.

Fourthly, limiting the operation of the Australian insider trading laws to listed financial products would align them more closely to corresponding laws in comparable jurisdictions.

3 CHAPTER 3 - MATTERS THAT SHOULD BE CHANGED

In approaching the twelve matters discussed in this Chapter, the AICD makes the general submission that the Advisory Committee follow the counsel of Lord Falkland[2] that: *when it is not necessary to change, it is necessary not to change.*

[2] Lucius Cary, Viscount Falkland (1610-1643). Secretary of State under Charles I (1642).

3.1 Strengthen the reporting requirements for directors

AICD is prepared to support the Advisory Committee's recommended changes to CA s205G set out in para 3.6, subject to the reservation that the expansion of the disclosure requirement to "trading through related parties", and the contraction of the disclosure period from 14 days to two business days, would make the requirement unduly and unnecessarily burdensome in relation to any benefit.[3]

Bearing in mind that a director in possession of inside information may not deal at all in the relevant securities, notification of a dealing by a law-abiding director *ex hypothesi* does not convey any price sensitive signal. To require disclosure within two business days would be to bestow an unwarranted sense of urgency that could mislead investors who are unversed in the insider trading laws into thinking that the dealing conveys a price-sensitive signal. AICD is, however, prepared to accept that 14 days may be seen to be an unduly long period, and would support the Advisory Committee's original suggestion in the 2001 Discussion Paper of five business days.

AICD does not favour extension of the disclosure requirement to the five most highly paid executives on the ground of its arbitrariness[4] or to "executives who report directly to the CEO", as that is not a concept to be comfortably incorporated in legislation.

3.2 Amend the test of generally available information

As stated earlier, AICD does not support elimination of the "readily observable matter" test as a trade-off for introducing a disclosable information concept into the definition of inside information. AICD notes the Advisory Committee's view that such a concept would cover the "excess stocks in the yard" example given in the EM to justify the ROM test; but to the AICD that is by no means *necessarily* the case: it would depend on the volume of excess stock and the reasons for its remaining in stock.

On the two suggested approaches to clarifying the ROM test, the AICD prefers the second on each of the three elements, that is:

[3] For the reasons set out in footnote 333 to the 2001 Discussion Paper.

[4] As pointed out in the 2001 Discussion Paper footnote 331, the idea is derived from CA s300A(1)(c). That provision was, however, not included in the consultation process for the Bill for the *Company Law Review Act* 1998, but was included at the behest of the Senate majority and conceded by the Government as part of the 'price' for enacting the Bill.

- *observable to whom* - disclosed in a public area or can be observed without infringing rights of privacy, property or confidentiality;
- *how observable:* a matter is readily observable even if other users of the market cannot obtain it because of limitations on their resources, expertise or competence, or because it is only available on payment of a fee; and
- *where observable:* a matter may be readily observable even if it is only available overseas.

3.3 Introduce rebuttable presumptions

As the Advisory Committee notes, to introduce rebuttable presumptions into legislation that carries criminal and civil penalties is a serious matter. That it is nevertheless favoured by the Advisory Committee is yet another example of how careless many law "reform" proposals are of the fundamental principle of the common law: *the presumption of innocence.*

Rebuttable presumptions involve bad policy and bad law. AICD sees them as intrinsically objectionable. We are greatly concerned that the justification cited, based upon *likely* access to inside information is to "… overcome the considerable evidential difficulties of independently proving subjective knowledge…". Directors and officers are entitled to the standard protections of the law and should not be prejudiced or discriminated against by virtue of office or employment.

AICD is concerned about the suggestions in paragraph 3.31 and 3.32, the first being that directors and other senior officers must fully inform themselves before transacting in the company's shares. The suggestion seems to be that there is an obligation to discover price-sensitive information, which would of itself be a disqualifying event. To suggestion that prior confirmation be obtained from the CEO would impose an extraordinary burden upon the CEO with attendant potential exposure. A CEO would be justified in refusing to provide such confirmation and, properly advised, ought to refuse. Additionally, it is information known to the particular officer that is relevant, not information known to the company.

AICD would also express concern that little regard seems to be given to the different management structures within companies and the different ways in which information, price-sensitive or potentially so, ebbs and flows. In a senior management team comprising, for example, CEO, CFO, chief information officer, general counsel/company secretary, GM human resources and GM public affairs, it may be that only three of the six are involved in the planning of, and are aware of, a rights issue. Most listed companies have strict rules imposed upon directors and senior officers, which prohibit share trading except in limited periods eg within 30 days of the announcement of half-yearly and yearly results (and even then not, if in possession of price-sensitive information).

3.4 Repeal the on-selling exemption for underwriters

As AICD noted in its submission on the Discussion Paper, the on-selling exemption does not appear to have caused any disquiet since its introduction in 1991. On that basis, AICD would not recommend that the exemption be repealed.

AICD is concerned that the Advisory Committee does not accept the likely effect of repealing the exemption on the cost and availability of underwriting. To AICD it is self-evident.

3.5 Repeal the statutory exemption for external administrators

AICD repeats its submission on the corresponding part of the Discussion Paper:

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

The exemption also does not appear to have given rise to any problems, and that alone justifies leaving the exemption alone. The Proposals Paper does not disclose what, if any, submissions the Advisory Committee received from the external administration community. Were they asked about the matter?

3.6 Clarify the relevant time for on-exchange transactions

AICD would join with the Advisory Committee in supporting the third option - that the relevant time is when the on-market offer is accepted by another exchange trader - as it is not until then that anyone has acquired or disposed of the relevant securities, which is a pre-requisite for the operation of CA s1043A(1).

3.7 Permit exercise of physical delivery option rights

AICD would again join with the Advisory Committee in supporting the principle of informed persons being able to exercise fixed price physical delivery option rights.

At the same, it has to be acknowledged that the reason why most people would go along with exempting the exercise of such an option from the insider trading laws is that it does not involve the *use* of inside information. That is something to which the Advisory Committee might usefully have adverted in its discussion in Ch. 4 of the Proposals Paper under the heading ***No use requirement***.

AICD would not, however, support a requirement for advance public notification by directors and senior officers before exercising such an option. As the Advisory Committee notes:

- the mandatory disclosure could be misleading; and
- it would need to be made clear how far down the corporate chain the test of "senior officer" would apply.

AICD considers that the same problem arises with disclosure by directors and senior officers of dealings generally: see para 3.1 above.

3.8 Extend the Chinese Walls defence to procuring

AICD notes that the Advisory Committee has been persuaded by unanimity of submissions that this change is necessary, and AICD agrees with this change.

3.9 Permit bid consortium members to trade for the consortium

Given the *régime* imposed by CA Ch.6, AICD agrees with the Advisory Committee's view that the "own intentions" exemption should continue to apply only to a person who trades on behalf of a bid consortium. However, AICD does not support that *régime.*

3.10 Protect uninformed procured persons from civil liability

The Advisory Committee's view reflects the view expressed in AICD's submission on the Discussion Paper.

3.11 Extend the equal information defence to civil proceedings

AICD agrees with the Advisory Committee's view, again reflecting unanimity of submissions on the Discussion Paper*,* that the insider trading legislation should provide an equal information defence in civil proceedings similar to the defence that applies in criminal proceedings.

3.12 Permit courts to extend the range of civil claimants

AICD doubts whether the likely (considerably) greater complexity that would arise from trying to define "contemporaneous traders" would be justified by any measurable improvement in the operation of the insider trading laws. There is nothing in either the Discussion Paper or the Proposals Paper to suggest any need, still less a pressing need, for legislative change down that path.

4 CHAPTER 4 - MATTERS THAT SHOULD NOT CHANGE

4.1 Regulate entities as well as natural persons

The requirement for Chinese Wall arrangements to enable a body corporate to deal without infringing the insider trading laws has been a feature of those laws since their introduction in 1975, and AICD agrees with the Advisory Committee in seeing no need for change.

4.2 Maintain only "information connection" approach

AICD notes that the Advisory Committee does not address the matters raised on this issue in its submission on the Discussion Paper. AICD is reminded of the law student in Professor Henry Manne's class who, during a classroom discussion demonstrating the difficulty of finding a satisfactory ethical or economic basis for prohibiting insider trading generally, stamped her foot and angrily declared "I don't care; it's just not right!"[5]

There is only one possible justification for imposing only an "information connection" test: that all participants in the relevant market must have equal access to "inside" information or, in other words, that knowledge and information are "free" goods that should be available freely to everyone.

One has only to spell out the argument to see its error: in real life, informational advantages provide the motivation for important aspects of almost every transaction in a market economy. Moreover, access to a particular piece of information is a function of the cost of obtaining it. In other words, more alert or skilled people, or people who have invested resources to develop their human capital in such a way as to assimilate information better, are always going to have superior access to information. Moreover, there are inevitably variations in the manner in which market participants assess information. The resulting inequality of information is a consequence of the division of labour and cannot justifiably be called unfair.[6] Indeed, Hayek in his celebrated paper *The Use of Knowledge in Society*[7], to which AICD drew the Advisory Committee's attention in its submission on the Discussion Paper, makes the point that the division of labour is the product of the division of knowledge.

That point is recognized explicitly in para. 1.20 of the Discussion Paper:

"Market participants with superior skill, time or commitment will therefore inevitably have a trading advantage."

They will often have that trading advantage by reason of acquiring in a perfectly lawful

[5] Hence, those who believe that insider trading should be prohibited on ideological, as opposed to reasoned ethical or economic, grounds have come to be known in the literature as *foot stampers*. Note that this is in the context of US law, which requires an "insider" to have a fiduciary duty to the relevant company. The counter-party on the source of the relevant information: Discussion Paper Appendix 6.
[6] See Jonathan R Macey *Ethics, Economics, and Insider Trading* Harvard Journal of Law and Public Policy, Vol 11 p785 at p799.
[7] Reprinted in F.A Hayek *Individualism and Economic Order* (RKP. London 1976)

way information that is not "generally available". Yet, it is precisely in that situation that such a market participant is prohibited by Australia's Insider Trading laws from trading! It is difficult to see much *market efficiency* in that.

How does the Advisory Committee justify the prohibition working that way in the name of *market fairness*? The answer lies in the linguistic legerdemain in the following paragraph in the Discussion Paper:

> *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. (Emphasis added).*

The legerdemain is, of course, in the use of *confidential,* which suggests to the unwary reader that information that is not "*generally available*" is necessarily information imparted or received on a confidential basis. That is certainly not the case under Australia's present insider trading laws.

Restoration of the "person connection" test would therefore not only bring Australia's laws more into line with those of almost all other comparable jurisdictions, but would also bring them into line with a reasonable notion of market fairness. One should also not overlook that what is essentially prohibited by Australia's insider trading laws - the exploitation of one's own discoveries - is precisely what is protected by our intellectual property laws.

In any event, the expression *market fairness* is in itself logically and linguistically inappropriate, applying as it does an adjective which characterizes human behaviour to the abstract entity of the market.[8]

[8] Like the complaint of a toreador that it was unfair of the bull to gore him.

4.3 Continue to exclude non-trading

In neither the Discussion Paper nor the Proposals Paper does the Advisory Committee address the central paradox that, if trading with the advantage of information not generally available is sufficiently heinous to merit severe criminal sanctions as well as civil liability, why is it that anyone may lawfully refrain from trading with the advantage of information that is not generally available. In moral terms, they are equivalently good or evil, depending on one's point of view. The paradox is by no means fully resolved by the argument that enforcement of such a prohibition would be practically impossible, but it is in AICD's view a sufficient argument to justify the Advisory Committee's recommendation against such a prohibition.

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

AICD supports the view of the Advisory Committee against imposing any obligation on a person lawfully disclosing inside information to inform the recipient that the information is inside information.

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

AICD notes from the appendices to the Discussion Paper that the EU Directorate requires information to be of *a precise nature*, and that the UK and South African legislation requires information to be *specific or precise.* The position in Germany and the US seems more or less the same as in Australia. To AICD, it is doubtful whether those requirements clarify usefully the notion of *information*, and so AICD would not advocate the adoption of such a requirement.

4.6 Should criminal liability for insider trading require that the accused has used or relied on the relevant information?

To AICD, if insider trading is to be made a crime, the essence of the crime must surely be the use or misuse of the relevant information. To object to a "use" requirement on the ground that "it would create a significant additional hurdle to effective enforcement of the insider trading laws" is very much the same as advocating the abolition of the need to prove *mens rea* on the ground of that it would enable more effective enforcement of the criminal law.

A law, like Australia's, which makes no distinction between:

- the liability of a director who makes use of inside information by buying or selling relevant securities; and
- the liability of a director in possession of inside information who sells under duress (eg at gunpoint or under pressure of commitments),

cannot be said to be exactly principled. That is no doubt why most of the comparable jurisdictions whose insider trading are outlined in the Discussion Paper - EU, UK, Germany, South Africa, Canada (Federal) require "*use*" as an element of the offence or, in the case of UK and South Africa, allow proof of non-use as a defence.

SEC Rule 10b5-1 makes an insider liable if that person trades "on the basis" of material non-public information, which surely implies an element of 'use', and in any event provides for a number of defences when the inside information is not a factor in the decision to trade.

Similar issues arise in relation to whether there should be an exemption for trading contrary to inside information.

4.7 Retain the communication and subscription exemptions for underwriters

AICD agrees that the communication and subscription exemptions are necessary for the effective functioning of the underwriting industry.

AICD has in its submission in Chapter 3 of the Proposals Paper expressed the view that the on-selling exemption should also be retained: see para 3.4 above.

4.8 Intermediaries to remain liable for aiding and abetting

AICD agrees that the current law, under which an intermediary who has knowingly received inside information from a client, or has been informed by the client that the client holds inside information, could be liable for aiding and abetting by trading in affected financial products for that client. Yet, the market effect of trading for that client would be no different from trading for that client without that knowledge. To make the intermediary liable in that context is likely to do no more than increase the level of deafness within the intermediary community.

4.9 No exemption for informed intermediaries acting for uninformed clients

AICD notes that submissions generally favoured permitting an informed intermediary to act for any uninformed clients on an execution-only basis, and suspects that the generally - held view among intermediaries is that it is perfectly lawful to do so. That may well be why no one appears to have brought clear evidence that the lack of an exemption has caused major problems.

AICD would support permitting an informed intermediary to act for uninformed clients on an execution only basis, as it is difficult to see any harm in doing so on any rationale for prohibiting insider trading.

4.10 No derivative liability for controllers

AICD agrees with the Advisory Committee's view that controllers or supervisors should not be subject to derivative civil liability for the activities of persons under their control or supervision.

4.11 No exemption for directors of takeover targets or their white knights

One of the more important tasks of directors of a target company facing a hostile CA Chapter 6 takeover bid will often be to attract as many higher counter-bids as possible, to the advantage of the target shareholders. There may be occasions when it is expedient for that purpose to communicate inside information to a potential counter-bidder. It is difficult to see a compelling reason for not allowing target company directors to do so, provided that the potential counter-bidder gives the target company an enforceable undertaking to keep the information confidential and not to acquire target company shares from uninformed counterparties before the information becomes generally available. If not before, that will occur with the issue of the bidder's and target's statements.

4.12 No obligation on Exchanges to publish their insider trading referrals

AICD agrees with the Advisory Committee that such an obligation would be inappropriate.

4.13 No differing criminal and civil insider trading regimes

Although AICD supports restoration of the "person connected" test as the delineation of an "insider", AICD shares the Advisory Committee's view against a proposal to confine criminal liability to fiduciaries and other person connection with the relevant entity. However, the fact that the proposal has been put to the Advisory Committee is in indication that such unfairness as is to be seen in insider trading is seen in the use of inside information by *real* insiders.

4.14 No recommended reform of ASIC's enforcement powers

In principle, AICD opposes giving the regulator the power to impose administrative penalties for insider trading because, whether any insider trading has occurred at all will, having regard to the nature and elements of the offence and the potential availability of a range of defences, seldom, if ever, be sufficiently clear-cut to justify such a power. Insider trading is not quite on the same level, or of the same character, as a parking infringement.

4.15 No change to compensation assessment rules

AICD agrees with the Advisory Committee that the existing rules for assessing what constitutes profit made or loss avoided should remain.

4.16 Retain civil remedies for companies whose securities are traded

In its discussion of this question in the Discussion Paper, the Advisory Committee seems to have assumed that insider trading in an entity's securities is always and necessarily damaging to the company. On the contrary, insider trading may alert the board of the entity to something affecting the company of which it is not otherwise aware, to the company's advantage. In that light, insider trading can be seen as a means by which information which cannot expediently be made known explicitly to the market by announcement can be made known implicitly to the market, and to the relevant company itself, through the price mechanism.

4.17 No speculative trading provision

As foreshadowed in its submission on the Discussion Paper, AICD agrees that there should not be any new statutory prohibition on "speculative trading" by directors and other corporate decision - makers.

4.18 No short swing profit provision

AICD supports the Advisory Committee's recommendation against a specific statutory prohibition on short swing profits.

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CHARTERED SECRETARIES
AUSTRALIA

Keeping good companies

15 November 2002

Mr John Kluver
Executive Director
CAMAC
Level 16
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SYDNEY NSW 2000

Dear John

Insider Trading Proposals Paper Sept 2002

Chartered Secretaries Australia (CSA) welcomes the opportunity to comment further on the matter of insider trading.

CSA is Australia's peak membership body for corporate governance and compliance, and firmly consider ourselves as fully qualified to respond to this matter. In Australia CSA has over 8,000 members representing the majority of public companies listed on the Australian Stock Exchange. Members of CSA regularly deal on a day-to-day basis with the ASX, ASIC and the ACCC and have a thorough working knowledge of the operations of the markets, the needs of investors and the law and regulation dealing with market practices and independence. In addition, representatives from the ASX, ASIC and the ACCC regularly address members at our seminars and conferences.

Whilst the Committee has endorsed many of the points made in our submission to the earlier paper, we remain concerned that the term "information" still does not provide an exemption where persons transacting are doing so on the basis of their own research, theory or deductions. CSA does not believe it should be left to the courts to adjudicate on cases where there is a degree of speculation or guesswork.

Set out below are our comments on the parts of the proposals paper covering the Sydney Futures Exchange, the OTC financial markets and the impact of the proposed new 'disclosable information element'.

Disclosable information element

Subject to our comment above, CSA supports the concept of 'disclosable information'.

As we understand it, the purpose of introducing the concept of 'disclosable information' is to restrict the ambit of the current definition of inside information in S.1042A by adding a third test to the definition, so that even if information is not generally available and is price sensitive it does not become inside information unless it is also of a type that a regular user of the market would reasonably expect to be disclosed at some stage.

It is not clear from the report precisely how the Committee envisaged introducing the new disclosable information element but we assume that something like the following formulation of S.1042A was envisaged:

"inside information means information in relation to which the following paragraphs are satisfied:

(a) the information is not generally available;

(b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products; and

(c) the information relates to matters that a regular user would reasonably expect to be disclosed to other users of the market on an equal basis, whether at the time in question or in the future."

The disclosable information element would make the definition more useful in situations like the "excess stocks in the yard" example referred to in paragraph 2.9 of the Discussion Paper (where the outcome should be that the information is not "inside information").

On the other hand, a realistic example where the disclosable information element would cause information to be caught by the insider trading prohibition would be where a government agency or other body inadvertently releases information earlier than it usually does (perhaps to a small number of people) in circumstances where market users typically rely on the official release in order to decide the price at which to trade. In this scenario market users may not know how widely the leaked information had been disseminated, so would not know whether it had become "generally available", but the presence of the disclosable information element would enhance the likelihood of market users, and a court, deciding that the information was within the "inside information" definition.

We doubt whether the disclosable information element would have altered the decision in situations like the Kruse and Firns cases (paragraph 2.14 ff of the Discussion Paper) (where the outcome should be that the information is "inside information") because of the continued presence of the "not generally available" test, which will always allow a court to find that information (even when subject to a delayed formal disclosure requirement) is nevertheless generally available, or "readily observable" in the right circumstances.

We believe the "excess stocks in the yard" and inadvertent public release scenarios are the types more in need of clarification/remedy, since the trend towards increasingly stringent corporate governance and disclosure obligations means a Kruse and Firns type scenario is less likely to occur in future.

CSA supports the arguments in paragraphs 1.25-1.41 of the Proposals Paper.

Sydney Futures Exchange and OTC financial markets

The disclosable information element would allow the insider trading prohibition to apply to those financial products where a reasonable expectation of reasonably imminent disclosure to the market exists.

The practical effect would be that in respect of those financial products (whether cash/secondary market or derivative market) where the price is likely to be influenced by various regular information dissemination processes that exist quite independently of any continuous disclosure obligation, trading in those derivatives will more clearly be subject to the insider trading prohibition. But in relation to other products where there is no reasonable disclosure expectation the prohibition will not apply. In relation to this latter category this is a sensible outcome, since if a product is such that there is no reasonable expectation of general disclosure of information, all information is secret so there is no need for the concept of inside information.

CSA supports the policy options in paragraphs 1.48-1.50 and 1.78, which will avoid an inappropriate division between exchange-traded and OTC products and subject financial products equally to the disclosable information element. This will allow the inside information prohibition to more closely match the needs of each market and is preferable to legislating formal carve-outs.

Naturally, we would be happy to discuss further with you any of the points raised above in our submission.

Yours faithfully

Tim Sheehy
Chief Executive

Commercial Law Association of Australia

Legislative Review Task Force

Submission to Corporations and Markets Advisory Committee

Insider Trading Proposal Paper

November 2002

Introduction

The Legislative Review Task Force (LRTF) of the Commercial Law Association of Australia (CLA) welcomes the opportunity to respond to the Insider Trading Proposals Paper (Proposals Paper) of the Corporations and Markets Advisory Committee (Advisory Committee) on the reform of the provisions of the Corporations Act 2001 relating to insider trading.

The CLA is a longstanding professional association devoted to bridging the gap between commerce and the law and is open to a wide range of members.

It is committed to representing the views of its members on legal and commercial matters directly to government. The CLA is regularly involved in providing comments and opinion to State and Commonwealth Governments on matters of law reform and legislative proposals. The LRTF has been established by the Council to ensure that the CLA's activity in this area is pursued and enhanced.

The CLA or LRTF have not previously commented on the current proposals for reform of the laws on insider trading as contained in the Advisory Committee's June 2001 Insider Trading Discussion Paper (Discussion Paper) and has approached the exercise with an open mind. Whilst some members of the Council of the CLA and/or the LRTF are involved in, or represent, participants in the financial services industry this submission should not be taken as necessarily representing the views of particular members of the Council or LRTF or their organisations.

Executive Summary

The LRTF is of the view that the reform of the insider trading laws should be undertaken with the desirability of four basic principles in mind:-

- effective enforcement
- reasonableness of compliance
- consistency across markets
- international harmonisation

The LRTF agrees with the majority of the current views of the Advisory Committee but has a number of comments to make having regard to the above principles. In particular the LRTF believes there is merit in applying the law beyond the organised markets subject to an appropriate limitation on the ambit of the provisions as a whole.

General Principles

As the CLA has not previously commented on the proposed reform of the law in this area, the LRTF feels it appropriate for it, to some extent, approach the matter from first principles.

The LRTF believes that there are four principles which should be borne in mind when amending the law in this area.

1. The need for effective enforcement
2. The reasonableness of the expectation of compliance
3. The need for consistency across markets
4. The desirability of international harmonisation.

Effective enforcement

It goes without saying that insider trading has often proved difficult to detect and enforce. Any legal regime should aim at ensuring that once detected insider trading is capable of enforcement within a clear legal framework. For this reason the LRTF is sympathetic to the view that exceptions of too great a complexity or ready manipulation by insiders should not be introduced without cogent reasons.

The reasonableness of the expectation of compliance

There is a danger with the complexity and breadth of the Corporations Law that the ability of even moderately advised persons to understand the law and its application is significantly compromised. The danger is that the introduction of complex provisions to prevent avoidance or so that exceptional examples of egregious conduct are caught, will mean that conduct will be rendered illegal which would not reasonably be expected to be. It is a dangerous principle that any overreach of the law can be rectified by prosecutorial discretion. Such an approach leaves potential defendants uncertain of the extent of their obligations and can amount to a system of selective law enforcement at the whim of the regulator. In the absence of a clear compliance line, the more prudent may be unduly limited in their commercial activities.

The need for consistency across markets

The LRTF believes that regulation should, where ever possible be consistent across markets and that regulation should be functionally based and not be unduly affected by market or trading structures. Adherence to this principle should avoid anomalies and loopholes and uncompetitive, unjust or inequitable results. The LRTF also believes that this refects the recommendations of the Wallis Financial System Inquiry as incorporated in the Financial Services Reform Act 2001.

The need for international harmonisation

Increasingly the markets for securities and other financial products and their participants are global rather than purely national in nature. In these circumstances, it is the growing expectation of market participants that cross border trading is facilitated by regulation which if not identical, is harmonised to the greatest extent possible. This factor in the efficiency and competitiveness of markets was also recognised in the Report of the Financial System Inquiry. Indeed, the health and competitiveness of the Australian economy can be influenced by the appropriateness of regulation. In its initial discussion paper CAMAC noted that in almost every respect Australian insider trading laws were already stronger in their terms than comparable overseas laws. The LRTF does not suggest that Australian regulation should be reduced to that applicable in overseas jurisdictions but it does believe that this is a factor which should be borne in mind when introducing provisions which are novel or significantly wider in their scope than applicable elsewhere.

Detailed comments on proposal paper

The remainder of this submission will comment on the Proposal Paper following the order and numbering in the paper. The submission does not deal with those areas where the LRTF believes that comment is best left to those more closely connected to the issues under discussion.

Chapter 1: Financial Market Transactions

In this Chapter the Advisory Committee raises some significant issues including

- The rationale for the regulation of insider trading
- The appropriate product focus of insider trading
- The extent to which the regulation of insider trading should extend beyond the organised public markets

It seems to the LRTF that all three of these issues are inextricably linked.

Again the LRTF believes it appropriate to consider these general issues before considering the specific issues raised.

Rationale for the regulation of insider trading

In its Discussion Paper the Advisory Committee raised for discussion the issue of the appropriate rationale underlying insider trading regulation. The Advisory Committee expressed the view that the market fairness and efficiency rationales are the most appropriate rationales for insider trading rather than what it sees as the more limited fiduciary duty or misappropriation rationales. The LRTF agrees that the market fairness and efficiency grounds are appropriate. However the LRTF believes that as suggested by a number of the existing provisions, there is still room for these alternate rationales. The fact that a provision does not address the market fairness or efficiency tests should not automatically render the provision inappropriate.

Whilst the market fairness and efficiency rationales for insider trading are today accepted as the primary rationales, we still believe that the fiduciary duty and misappropriation rationales which reflect tried and tested general law have a place. Indeed it can be argued that insider trading regulation developed as an extension of the duty that company officers owe to shareholders as a whole, to prospective individual shareholders.

While the person connection test remained in place and regulation was limited to securities and associated derivatives, establishing the rationale for insider trading was not vital, except perhaps with respect to the question of the extent to which insider trading regulation should extend to off market trading,. However the Advisory Committee has correctly identified that the abolition of the person connection test in previous reforms and the extension to financial products other than securities has made identifying the rationale for the regulation of insider trading important.

Appropriate product ambit

As the Advisory Committee points out, the major change effected by the Financial Services Reform Act 2001 has been in relation to derivatives, as now all derivatives (including futures contacts) are within the ambit of the insider trading provisions. It is regrettable that this major change in the Financial Services Reform Act did not await the current review and an adequate consultation process rather than being swept up in the Financial Services Reform Bill process.

The difficultly with extending the regulation of insider trading in this manner is that it divorces the regulation of derivatives from the underlying commodity, whilst under the old regime trading in securities and a related derivative were equally prohibited. This means for example that if someone has "inside information" affecting the price of a particular commodity he is permitted to buy or sell the physical commodity but can not made an economically equivalent trade in a derivative and will be subject to major penalties if he does. The other effect of this extension is that it introduces greater complexity in relation to exactly what information is regarded as inside information. For example, what is generally available or readily observable in relation to a foreign underlying commodity? For these reasons the LRTF believes that careful consideration need to be given to what products should be covered by the provisions. Generally a limitation to equity and MIS products as under the previous regime appears appropriate. Extension to government securities might also be considered.

We comment further on the effect of the current product focus (as recently extended) in our detailed comments particularly in relation to the question of the application of insider trading laws to OTC trading.

Extent of application of provisions to off market trading

In general the LRTF believes that if insider trading is to be prohibited in relation to particular information or products, it should be prohibited regardless of whether the activity is conducted on market or off-market or on an over-the-counter market. Whilst the current application of insider trading laws to off market activity may be seen as a remnant of the fiduciary duty or misappropriation rationales. As we have said, we believe that such rationales still have some relevance. Further. to take a different view seems to leave the provisions open to anomalous results. The remedy to the inappropriate application of the provisions appears to lie in careful consideration of the products to be within the ambit of the provisions and the available defences. The LRTF takes this view in the light of its general principle that there should be consistency across markets, and in this context believes that a wide meaning needs to be given to market beyond that strictly occurring on the public organised markets. It is also noted that the Financial System Inquiry took the view that market forces rather than legislation should determine whether a transaction is conducted on exchange or on an OTC market.[1] The advance of technology and globalisation with its blurring of lines between national markets and between traditional and other markets reinforces this point.

Application to transactions on ASX and other stock exchanges (1.17 ff)

We note that for convenience the Advisory Committee refers to the ASX whilst noting that there are also other stock markets in existence. As a general matter we would express the view that any provisions should be generic in nature rather than specially directed at current entities or market structures. Unless this approach is

[1] Wallis Financial System Inquiry Recommendation 22.

taken in these and other legislative reforms, given the pace of change in the financial markets the harmonisation attempted by the Financial Services Reform Act will be lost.

Disclosable Information Element (1.22 ff.)

In principle the LRTF supports the disclosable information element as a means of placing understandable boundaries around the meaning of inside information in accordance with the principle that legislative requirements should be reasonably susceptible to compliance.

Readily observable matter (1.40 ff.)

The proposal paper suggests that the disclosable information element may eliminate the need for this defence. Whilst such information may well be excluded by the disclosable information element it seems to the LRTF that there may be merit in retaining this defence, particularly having regard to the current extension of the provisions beyond securities.

Sydney Futures Exchange (1.42 ff.)

Again, whilst the proposal paper refers to the Sydney Futures Exchange (SFE) we would make the point that as far as possible legislative provisions should be generic in nature and refer to markets for particular types of product rather than particular entities or existing market structures.

For the reasons stated earlier the LRTF believes there is considerable merit in restricting insider trading laws regarding derivatives to the securities based products applicable under the previous law. Alternatively a continued application of those laws to non equity/non MIS products should be based on a proper analysis of the rationale for that approach and the likely effects and benefits. We would agree that it would be very difficult to distinguish risk management (hedging) from trading (speculation) for the purpose of insider trading laws.

OTC Markets (1.51ff)

In general the LRTF has difficulty with the general proposition that insider trading laws should not apply to OTC markets. In particular it appears illogical that a trade which attracts severe penalties and civil liability if done on market, is perfectly legal if done away from the organised markets. Some of the arguments advanced could equally be argued by participants in the organised public markets (see paragraph 1.64 for example). Further it may be inappropriate to make law based on assumptions about the nature of activity and participants in the current OTC markets. As history has shown markets are prone to change much faster than anticipated. This is particularly so given the greater permitted scope for retail OTC trading following the enactment of the Financial Services Reform Act. The introduction of this limitation would also raise complex issues as to whether the regime should be limited to Australian licensed markets, or if not, how the regime should apply to trading on overseas markets (e.g. re dual or other overseas listings) and if so how such markets should be defined (see section 1002 for the extraterritorial reach of the current provisions).

However, it does appear that the extension of insider trading to OTC markets as a consequence of the extension of insider trading laws to all financial products was not properly considered. A reduction in the product focus of these laws to securities based products as under the previous law (equity and MIS), for example should presumably remove the concern held by the OTC markets. As the proposal paper notes insider trading laws have always applied to equity based OTC (or off-market) products.

As regards the policy options discussed in the Proposal Paper (1.68 ff.) the LRTF has the following comments

Exempt all OTC transactions from the insider trading laws

For the reasons stated above the LRTF does not support this proposition. Were it to be adopted at the very least any exemption or "safe harbour" should only be applicable to sophisticated parties and transactions exceeding specified values to reflect was is currently understood to be the OTC market.

Limit insider trading laws to linked products

The LRTF does not believe that this limitation is appropriate as a matter of principle but its object would largely be accomplished if insider trading laws were limited to "security" (i.e. equity and MIS) based products.

Limit insider trading laws to disclosable information

In principle the LRTF would support a disclosable information element in relation to OTC markets however the problems with this approach identified in the Proposal Paper would need to be resolved to ensure consistency across markets. Again this issued would largely be resolved were the provisions to be limited to security based products as discussed above.

Exempt and emerging markets (1.82 ff.)

The LRTF does not believe that special rules should apply to exempt or emerging markets although the disclosable information element may apply differently

Chapter 2: Possible carve-outs

We have the following comments on the matters raised.

New Issues (2.2ff.)

The LRTF agrees with the reasoning of previous submissions that inside information held by issuers is best left to disclosure laws. We also agree with the Advisory Committee that offerees who subscribe to new issues should be subject to the insider trading regime.

Entity making an initial placement (2.10 ff.)

The LRTF also tends to agree with the view that individual placements should be excluded from the provisions. We also agree that placees should be included.

Buy-Backs (2.20ff.)

For similar reasons to those in relation to placements and issues, the LRTF is inclined to the view that buy backs should continue to be excluded and offerees should continue to be caught by the provisions.

In line with the guiding principles articulated at the outset we also believe that the fact that exclusion would place Australia out of line with other relevant jurisdictions is also a relevant factor.

Private transactions in exchange –tradeable financial products (2.28 ff.)

For the reasons stated at the outset the LRTF does not believe that transactions off market should necessarily be excluded. The fact that such transactions are currently included suggests that the legislation has a wider rationale than would be achieved by a limitation to exchange traded transactions. Once one accepts the underlying insider trading regime it is difficult to accept problems in particular cases as a reason for special treatment without raising legitimate questions as to whether similar considerations should not be applied elsewhere, for example in relation to an offeree obliged to decline a special placement or buy-back offer. On this basis the LRTF would support the continued application of the insider trading regime to such transactions but would also support the application of the disclosable information element, where made applicable, to exchange traded transactions. Our views here are consistent with those expressed with respect to off-market and OTC transactions generally.

Transactions under non-discretionary trading plans (2.36 ff.)

In principle the LRTF would support the introduction of the safe-harbour provided by U.S Rule 10b5-1 subject to the Advisory Committee being satisfied that the avoidance safeguards are adequate.

Transactions in unlisted entities (2.44 ff.)

In general, consistent with its earlier comments the LRTF would not be in favour of any general exemption for unlisted entities or the proposed required link to listed entities. However the LRTF would support an exemption for small businesses properly defined.

The LRTF does note the Advisory Committees comment that most jurisdictions limit their insider trading laws to listed securities or instruments linked to listed securities. Query whether this includes the United States from which Australian insider trading laws were originally derived at least in part.

Chapter 3: Matters that should be changed

The LRTF has the following comments on the matters raised in this Chapter

Strengthening of reporting requirements (3.3 ff.)

The LRTF would generally support disclosure requirements which ensure proper disclosure of relevant dealings but does not wish to comment on the detail of the Advisory Committee proposals at this stage.

Amendment of test of generally available information (3.8 ff.)

Readily observable matter (3.10ff.)

As noted earlier we think there still may be some room for a "readily observable test" even if the disclosable information element is adopted.

If the test is retained, to avoid uncertainty, we would support the current approach to the test.

Introduction of rebuttable presumptions (3.25 ff.)

In general the LRTF has concerns that whilst aiding enforcement, the reversal of the onus by proof by the introduction of rebuttable presumptions is inappropriate. We also have a doubt as to the practicality and likely availability of the certificate from the Chief Executive.

Repeal of on-selling exemption for underwriters (3.34 ff.)

The LRTF supports the proposed removal of the on-selling exemption for underwriters.

Repeal of statutory exemption for external administrators (3.38 ff.)

Whilst the LRTF understands the principle underlying the view that Administrators not be exempt this has to be balanced against the desirability for administrators to be able to efficiently undertake their task and that there be persons willing to take on this task. In the absence of evidence of abuse of the current exemption the LRTF would suggest that a change should only be made after careful consideration and consultation with representatives of the persons affected.

Relevant-time for on-exchange transactions (3.42 ff.)

The LRTF agrees that the time of the trade is, on balance, the relevant time for a transaction.

Exercise of physical delivery option rights (3.47 ff.)

In general the LRTF supports the Advisory Committee views in this area.

Extend the Chinese Walls defence to procuring (3.58 ff.)

The LRTF supports the extension of the Chinese Walls defence to include procuring.

Permit bid consortium member to trade for the consortium (3.63 ff.)

The LRTF agrees that the "own intentions" defence should apply to a person who trades on behalf of a consortium.

Protect uninformed procured persons from civil liability (3.66 ff.)

The legislation in referring to the procurement of another person to purchase securities seems to be envisaging a situation where the other person is in effect acting at the behest or on behalf of the insider. If this is so it appears unlikely that an insider would not have an interest in a procurement. However, the LRTF agrees that there need be no civil liability where the insider did not receive any direct or indirect benefit (perhaps by reference to the concept of associated person). However it would seem that this should also include potential benefit, to cover the situation where an intended benefit did not eventuate.

Extend the equal information defence to civil proceedings (3.70 ff.)

On the basis that the equal information defence is agreed to be sound, the LRTF agrees that the equal information defence should also apply in civil proceedings.

Permit courts to extend the range of civil claimants (3.74 ff.)

The LRTF agrees that the Court should be given the discretion to extend the range of claimants beyond the immediate counterparty.

Chapter 4: Matters that should not be changed

The LRTF agrees with most of this Chapter but has the following comments.

No requirement to inform recipients that they are receiving inside information (4.15 ff.)

The LRTF notes that the Advisory Committee has accepted the view that such a requirement is unworkable. Without being aware of the basis on which this view was taken the LRTF would have thought that reference might be made to the well established law relating to the treatment of confidential information to encourage procedures to guard against actual or alleged inadvertent misuse of such information intentionally or otherwise.

No exemption for directors of takeover targets or their white knights (4.48 ff.)

The LRTF agrees that no statutory exemption should be provided but queries that basis of the suggestion that the matter should be left to industry best practice. Does this envisage that such practice will somehow supplement or override the law in this regard?

Retain civil remedies for companies whose securities are traded (4.68 ff.)

The LRTF supports the continuation of this provision. Apart from the reasons given in the paper we believe this is a valid manifestation of the continuing relevance of a fiduciary rationale for the regime.

General Conclusions

The LRTF thanks the Advisory Committee for the opportunity to comment on the Proposal paper. We believe that it is important that the law is continually reviewed for relevance having regard to the changing marketplace, experience with the operation of the existing law and the development of similar laws internationally.

We believe the current law provides a reasonable basis for the law in this area. We wish the Advisory Committee well in its further work. We would commend to the Committee the principles enunciated at the outset as a basis for consideration of not only our comments but of other parties and in the final development of the Advisory Committees recommendation to Government.

The Commercial Law Association of Australia and the LRTF would be very happy to further assist the Advisory Committee in its deliberations.

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8 November 2002

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

Dear Mr Kluver

ESAA comments on the Proposal Paper

We refer to the recent CAMAC Insider Trading Proposals Paper (the Proposal Paper) released in September 2002.

The Electricity Supply Association of Australia (the ESAA) is a peak industry body for the electricity supply industry in Australia. The ESAA is uniquely positioned to comment on the application of insider trading provisions to electricity hedging as its membership incorporates retailers, wholesalers and generators. This means that the ESAA's membership includes representatives from all of the various segments of National Electricity Market ("NEM") participants with a direct interest in the regulation of OTC electricity derivative contracts.

Because electricity hedge contracting is an extremely important part of the management of risks of trading in the wholesale electricity market a number of the ESAA's generation and retail businesses requested the ESAA to establish whether there was a common view across these sectors on issues raised by insider trading prohibitions on electricity hedge contracting, and if so, to respond to the paper expressing a collective view of both sectors. This submission is the outcome of that process. Across the generation and retail sectors support has been expressed for the views it outlines, although one member, Energy Australia, has indicated that its views differ with those set out in this response and I understand will write separately to you on its views.

1. INTRODUCTION

Electricity hedge contracts among participants in the NEM, such as generators and retailers, are now regarded as a universal and necessary feature of the participation of such parties in the NEM. The primary purpose of these contracts is to hedge the exposure of NEM participants to fluctuations in the spot price for electricity in the NEM.

2. REFORM

As you are aware, from March 2002, the effect of Part 7 of the Corporations Act introduced by the *Financial Service Reform Act 2001 (Cth)* ("**FSRA**") is to apply insider trading prohibitions to hedge contracts that are based on the price of electricity in the National Electricity Market ("**NEM**").

This appears to be part of a general policy to regulate all "financial products" in the same way. Whether or not it is intentional, because of the width of the definition of "financial products", electricity hedge contracts are now caught by the provisions.

There are two exemption mechanisms in the legislation which allow products or services to be declared not to be financial products. Section 765A of the Corporations Act relevantly provides for things to be declared not to be a financial product either by:
• regulation; or
• ASIC gazetting a notice to that effect.

We infer that these mechanisms were included in the legislation because of the likelihood that products which may be found to be unsuited to the new regime (such as electricity hedge contracts) would be caught by the width of the new definitions.

3. EXECUTIVE SUMMARY

The ESAA supports and endorses the comments made by CAMAC in the Proposal Paper (at 1.63 to 1.65) about the inappropriateness of applying insider trading laws to OTC markets generally, and electricity derivative contracts in particular.

The ESAA notes that the application of insider trading laws to OTC electricity hedge contracts was not requested, needed, publicly debated or supported by industry participants. Moreover, the application of the insider trading provisions to electricity hedge contracts does not meet the policy objectives of those provisions, and is not necessary or desirable, because:

- NEM is a private market in which only sophisticated participants are involved;

- All participants are large Australian Corporates, therefore there is no "consumer protection" rationale for the changes;

- it is not necessary for market fairness; and

- it does not improve market efficiency.

The ESAA submits that it is logical and appropriate that wholesale electricity hedging be exempt from the insider trading rules. Such rules are appropriate in multi-party, public, retail, anonymous, purely derivative markets where there is an expectation, market rule, legislation or need regarding continuous disclosure or equality of information. By contrast, asymmetric information is an accepted, and structurally embedded, element of the NEM.

Electricity hedge contracts are fundamentally different to the public, on-market transactions (such as ordinary share transactions) for which insider trading rules are properly intended to operate.

We note, in this regard, that electricity hedging is:

- specialised and undertaken by informed participants;

- bilateral;

- private;

- between identified counterparties (i.e., not anonymous), where there is a clear acceptance that there will be asymmetrical market knowledge and no assumption of full disclosure or equality of information;

The insider trading rules should also not be applied to electricity derivative contracts, as the rules are likely to conflict with the disclosure and bidding provisions of the Code. These provisions are designed to reduce the private sharing of market information between NEM participants and the risk of anti-competitive agreements between NEM participants in breach of the *Trade Practices Act 1974*. Requirements about disclosure of supply and demand information between electricity hedge counterparties may encourage such anti-competitive agreements, disadvantage other market participants and decrease the efficiency of the NEM.

In the past, all participants in the wholesale electricity market operated under exemptions from the futures trading provisions of the *Corporations Act.* The same rationales which supported those exemptions justify the exemption of wholesale electricity trading from the new insider trading provisions.

One of the key aims of regulating insider trading is the protection of unsophisticated consumers. There is no suggestion that such consumers are involved or at risk in relation to trading in electricity derivatives. It is entirely a wholesale market.

Of the various policy alternatives considered by the CAMAC, theESAA agrees that a full exemption for electricity derivative contracts is the approach which is the most intelligent and cost-effective, least intrusive and has the most public benefit.

The ESAA considers that alternative policies such as limiting the application of insider trading laws to linked OTC products or disclosable information, will not provide sufficient benefit, in the case of electricity derivatives, to warrant the greater complexity, risk and legal uncertainty these hybrid rules would bring to the market. In this regard, it may be necessary to distinguish electricity derivative contracts from other OTC products.

4. INSIDER TRADING – A GENERAL OVERVIEW

4.1 Scope

As the Committee would be aware, prior to the introduction of the new rules, the scope of the prohibition on insider trading was confined to dealings in "securities" (which consisted of shares, bonds, debentures, units in trusts, options etc). Dealings in derivatives and many other products or services, such as buying and selling real estate, were not regulated.

One of the continuing problems with the regulation of insider trading is the apparent arbitrariness of its scope. For many years in Australia, insider trading in shares was prohibited, whereas it was permitted in relation to share price index derivatives.

The recently passed FSR Act, repealed Chapters 7 and 8 of the Corporations Act and inserted a new Chapter 7 dealing with “financial services markets”. As part of this process, the FSR Act inserted new insider trading provisions, namely, Division 3, Part 7.10 of the Corporations Act, and expanded the coverage of those provisions by extending their traditional operation from “securities” to all “relevant Division 3 financial products”.

The term “relevant Division 3 financial products” includes derivatives1, managed investment products, certain superannuation products, or any other financial products that are able to be traded on a financial market.

1 The term “derivative” is defined as an arrangement under which the following conditions are satisfied:

• a party to the arrangement may be required to provide at some future time consideration of a particular kind to someone;

• that future time is not less than the number of days, prescribed by the regulations, after the day on which the arrangement is entered into;

• the amount of the consideration (or value of the arrangement) is ultimately determined, derived from or varies by reference to the value or amount of something else, including for example a commodity.

A commodity is anything capable of delivery, which arguably includes electricity.

A relevant Division 3 financial product in relation to inside information is likely to include offering and entering into arrangements in the nature of electricity hedging contracts, unless such arrangements are exempted from the operation of those provisions.

Given that an electricity hedging contract is a derivatives contract and therefore a Division 3 financial product, the prohibitions under section 1043A of the new Part 7.11 will apply to entering into such contracts if one of the parties:

(a) possesses information that is not generally available;

(b) knows, or ought reasonably to know, that the information is not generally available; and

(c) knows, or ought reasonably to know, that a reasonable person would expect the information, if it were generally available, to have a material effect on the price or value of the relevant hedge contract.

The ‘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 party.

Specifically, section 1043A says that the insider must not:

(d) apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

(e) procure another person to apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

(f) (f) if the relevant Division 3 financial product is able to be traded on a financial market in Australia, communicate inside information to another person, or cause it to be communicated, if the insider knows, or ought reasonably to know, that the other person would be likely to:

   (i) apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products; or

   (ii) procure another person to apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of relevant Division 3 financial products.

The new Chapter 7 is intended to eliminate the current distinction between securities and futures contracts by implementing a more flexible regulatory framework for financial markets. However, the new regime readily recognises that many “financial products” might not be appropriately regulated by the insider trading prohibition. Not only are many things excluded from the definition of “financial product”, but there is both a power in ASIC and a regulation making power enabling certain “financial products” to be excluded from the regime.

In our submission, electricity derivatives are a ready and important candidate for exemption.

4.2 Policy Rationale for Insider Trading

Various theories are put forward in support of regulating insider trading. They range from the "market efficiency" and "market fairness" rationales, to concepts of fiduciary duty and misappropriation (canvassed by the CASAC in Chapter 1 of the Discussion Paper).

As discussed below, the ESAA does not consider that any of these various rationales support the overreach of Part 7 into OTC electricity derivative contacts.

4.3 Penalties

The insider trading provisions carry the highest penalties of any offence under the *Corporations Act* (ie a maximum fine of $220,000 or imprisonment for 5 years for a natural person and a maximum fine of $1,100,000 for a corporation). It is an extremely serious offence.

There should, therefore, be a clear reason for the application of the prohibition in relation to a particular market or trading activity.

4.4 A BRIEF COMPARISON OF OTC DERIVATIVE CONTRACTS AND ONEXCHANGE SHARE DEALINGS

The classic context for regulating insider trading is dealings in ordinary shares. The market value/price of shares generally involves a mixture of:

(a) An assessment of future maintainable earnings;
(b) Analysis of the track record of the company;
(c) Net tangible asset backing per share;
(d) Market and industry factors;
(e) Quality of management, business plan etc;
(f) Assessment of foreseeable risks affecting the company; and
(g) Intangible factors, rumour and speculation.
(h)

With so many intangible factors affecting the assessment of the value of shares in a company, it is easy to see why it is necessary to regulate insider trading in shares.

Electricity, on the other hand, as a commodity, is not subject to as many “intangibles”. It is a professional market. Rumours, tips and market “hype” are not mischief that the law should be seeking to regulate in the context of electricity hedging.

4.5 What is Price Sensitive Information Regarding a Share?

Price sensitive information, in the context of shares, can include all kinds of subjective information (for example, the identity of a person about to be appointed as a director). In the context of electricity hedging, inside information relates directly to the commodity being traded and is generally confidential to the party involved.

4.6 What is Price Sensitive Information in an electricity market?

Information in the possession of one of the parties to an electricity derivative knows, or ought reasonably to know, is not generally available will constitute inside information if a reasonable person would expect it to have a material effect on the price or value of the relevant hedge contracts.

By virtue of their roles as major producers, purchasers and traders of electricity, those parties will at times be in possession of information of this nature. This will include data such as plant availability, generation and demand levels, load curtailability, new generation proposals, price forecasting, market analysis, weather forecasts, regulatory uncertainty, operating and capital cost conditions, general electricity trading conditions and details of some existing contracts. This is no different from a producer of other commodities with expert knowledge about their business (eg oil, sugar, wool, interest etc).

Much of that data could reasonably be expected to have a material effect on the price at which the counterparty will be willing to enter into the hedge contract.

Accordingly, contracting parties would be required to disclose information about plant availability, production and demand, and the myriad of other details (above) with other parties before engaging in bilateral hedging. Many of these matters are outside the scope of, and most likely in conflict with, the statutory disclosure requirements in the National Electricity Code and the authorization of the Code which has been granted by the Australian Competition and Consumer Commission under the *Trade Practices Act*, as well as being beyond the scope of market regulation generally regarded as being efficient.

4.7 CASAC Discussion Paper

CASAC circulated a Discussion Paper on Insider Trading in June 2001 (the Discussion Paper). The Discussion Paper supports the view that the market fairness and market efficiency rationales for prohibiting insider trading are only concerned with the impact on public markets. The extension of the prohibition to privately traded commodity derivatives is less logical.

In the case of electricity hedge contracts, although the NEM spot market (the pool price) is technically a public market, the relevant market for electricity hedge contracts is a quite distinct bilateral market between large corporates. Therefore, requiring public disclosure so that parties may engage in bilateral hedge contracts is misguided.

Electricity hedge contracts are private transactions, not transactions conducted on a public market. In other words, it is more like a property or asset sale than trading in a security. Private transactions are regulated by private and statutory contract law (such as the *Trade Practices Act 1974*), which prohibits misleading and unconscionable conduct. This is currently and in the future a more limited and appropriate basis for regulation of electricity hedge contracts.

5. The Proposal Paper

Most recently, CAMAC considered the appropriateness of the application of insider trading laws to OTC financial markets in the Proposal Paper. The ESAA endorses the comments made by CAMAC in relation to the OTC derivative market, and especially in the context of electricity derivatives.

The ESAA notes with approval the contrasting features of OTC and exchange markets identified by CAMAC (at paragraphs 1.56-1.59):

- Unlike public markets, OTC markets are personalised and bilateral with very little opportunity for any retail participation.

- OTC transactions are subject to negotiation between the parties, rather than standard, fungible on-market securities (in that the terms of the ISDA may be varied by the parties).

• It is accepted by the parties that the terms and prices of many OTC contracts may never be disclosed and (subject to the limited disclosure requirements under the Code) are not required to be disclosed.

The ESAA agrees with CAMAC that the insider trading laws should not seek to interfere with or override mutually agreed contractual terms relating to disclosure in private, bilaterally negotiated contracts (at paragraph 2.31).

The ESAA also accepts the comments made by CAMAC (at paragraph 1.63) about the potential for insider trading laws to substantially interfere with the portfolio management and risk management functions of all parties to OTC electricity contracts. The ESAA is concerned about the increased compliance costs and legal uncertainty (including possible criminal sanctions) which may face its members when negotiating OTC contracts in an environment in which current insider trading rules apply.

6. ELECTRICITY TRADING – REGULATORY CONTEXT

6.1 NEL, NEM, CODE – A Mandated Market

The *National Electricity Law* (and the *National Electricity Code* (“***the Code***”) thereunder) requires spot electricity to be sold by generators to the market manager, NEMMCO.

6.2 NEMMCO & the Pool Price Algorithm (SPD)

NEMMCO then sells that electricity to electricity retailers for the *pool price,* which is set every half hour based on the highest accepted bid submitted to NEMMCO by the generators and determined by an algorithm (the “**SPD**”).

The electricity wholesale market is volatile. Unlike many commodities, electricity cannot be stored pending favourable market conditions. Electricity retailers are forced to manage the consequent risk of price volatility through hedging with generators. The unavailability of hedging, for example because of the imposition of insider trading restrictions prohibiting market participants who hold price-sensitive information from transacting hedges, would inevitably lead to market participants seeking additional risk premiums in their pricing. Some jurisdictions have responded to such price escalation with artificial regulatory price “capping”, however there are a number of shortcomings in that approach.

6.3 The need for hedging - Price Volatility and Capping (VoLL)

As electricity cannot be stored, electricity retailers are always obliged to buy it from the pool at the prevailing pool price. As a result of this obligation, retailers are subject to an unmitigated price volatility risk and can be obliged to pay up to the maximum pool price (which is known as (“**VoLL**”) which, as of April 2002 went from $5,000 to $10,000/MWh.

The only mitigation strategy available for retailers or generators to manage this price volatility is to enter into bilateral electricity derivatives. This is usually done in a standard OTC form with written confirmations under an ISDA contract and special electricity terms included by way of schedule.

Such a contract might be struck at, say, $50/MWh so that the retailer would pay the wholesale generator the difference between the pool price and the $50/MWh contract price at all times during the life of the contract when the pool price was below $50/MWh and the generator would pay the retailer the difference between the pool price and the $50/MWh contract price when the pool price was above $50/MWh. This exchange of different payments achieves a net *pool plus contract price* to the retailer of $50/MWh which is of inestimable value to the retailer in immunising itself from raw pool price volatility. Even if the pool price goes to $10,000/MWh (ie VoLL), the retailer will still only end up paying in effect, $50/MWh.

Such contracts may be unworkable if the insider trading rules apply to wholesale electricity hedges because one of both counterparties may effectively be prohibited from entering into the necessary contract. Generators always risk having some confidential and potentially price sensitive information about generation capacity and bidding strategies. Retailers will always risk having confidential and potentially price sensitive information about load, curtailability of load and demand side management.

6.4 Adequate Existing Disclosure Requirements - Disclosure of Generation Capacity under the Code

The ESAA also notes that disclosure and use of information is already appropriately regulated in the NEM and the agreed terms of OTC contracts.

The National Electricity Code requires generators to provide a large quantity of information to NEMMCO in order for NEMMCO to plan the operation of the NEM and identify potential power system security problems. This information includes 2-year advance notification of the availability of each generating unit for each day and energy constraints applying to each generating unit.

NEMMCO is required to collate this information and publish information in order to assist Market Participants to plan scheduled work on plant and to inform them of any possible power system security problems. This information includes aggregate generating unit availability for each region and days when low reserves of generation capacity are expected.

Although much of the longer-term information refers to the electricity regions rather than individual generators, the nature of the electricity industry is such that, if a reduction in generating capacity for the region is indicated, it is not difficult to identify which generating unit(s) may be responsible for that reduction, simply on the basis of the lost generating capacity.

In addition, generators are effectively prevented from taking advantage of their knowledge of plant availability because generators are obliged to publicly disclose plant availability through the NEMMCO Projected Assessment of System Adequacy ("**PASA**) process.

6.5 Asymmetric Information as Between Generators and Retailers is Accepted in the NEM

Asymmetric information is an embedded and accepted feature of the NEM.

Electricity generators, traders and retailers will often be in possession of confidential information which is likely to affect the price of electricity in the National Electricity Market or the prices at which counterparties are willing to enter into electricity hedge agreements. This information is unavoidably acquired by those parties by virtue of their roles in the National Electricity Market. It includes information about the availability or likely availability of generation capacity, changes in the demand for electricity and the curtailability of that demand and the existence and details of other significant electricity hedge contracts (and the other information outlined above).

Under the insider trading provisions, generators and retailers in possession of such information would be prohibited from entering into electricity hedge agreements without disclosing the information to the prospective counterparty.

This disclosure of information would be:

(a) inconsistent with the provisions in the Code which require generators to disclose real-time information about the amount of generation capacity available but does not require retailers to provide any real-time information regarding the likely demand for electricity or the curtailability of that demand;
(b) inconsistent with the intention and terms of the authorization of the National Electricity Code by Australian Competition and Consumer Commission;
(c) unnecessarily prejudicial to the commercial interests and confidentiality of the party required by the insider trading provisions to disclose the information; and
(d) not necessary to meet the objectives and rationale of the insider trading provisions.

7. LACK OF POLICY RATIONALE REGARDING ELECTRICITY HEDGING

There is simply no point in subjecting some financial activities to an insider trading prohibition. In the case of electricity derivatives, where consumer protection and market integrity concerns are not present, the ESAA submits that there is no adequate policy rationale supporting the application of insider trading laws.

8. APPLICATION TO ELECTRICITY FUTURES

The ESAA also submits that a number of arguments in support of an exclusion for OTC derivatives may also apply to market traded electricity futures (currently traded on the SFE).

9. DETRIMENTAL EFFECTS OF EXPANDED APPLICATION

9.1 Retailers Might Not be Able to Get Funding Support

The unavailability of hedging has the potential to create other regulatory compliance issues for market participants. The National Electricity Code provides that NEMMCO can require retailers to lodge a security in the form of a bank guarantee to cover the retailer's exposure to the pool. With the increase in the maximum pool price from $5,000/MWh to $10,000/MWh, the potential exposure of retailers to the pool has increased. Providers of bank guarantees may be reluctant to provide the security on behalf of market participants who are unable to manage price risk effectively, or may be inclined to add a significant risk premium to their fees, with an inevitable flow-on to the cost of electricity.

9.2 Retailers Could Fail or Consumers Would Suffer

The ESAA submits that it is likely that, if electricity hedging remains subject to an insider trading prohibition, a premium necessary to absorb unhedged risk may be passed on to consumers.

10. POSSIBLE RESPONSES TO THE NEW PROVISIONS

10.1 Chinese Walls Would Not be Financially Prudent

Chinese walls are often a first port of call solution to insider trading problems. The idea is that an organisation isolates the securities trading operations from other areas that would be likely to be in possession of price sensitive information.

CAMAC noted in the Position Paper that the Chinese wall defence is generally not practical or available to parties involved in OTC electricity contracts (as well as standard commodity market futures). The ESAA agrees with CAMAC that the use of Chinese Walls when negotiating OTC electricity hedges would, to a very large extent, defeat the purpose of these contracts.

11. POLICY OPTIONS

CAMAC has raised, in the Proposal Paper, several policy alternatives for consideration in relation to this issue. Of these, the ESAA strongly supports the exemption of all electricity derivative transactions from the application of insider trading laws, for the reasons stated in this submission.

11.1 Exemption for OTC electricity derivatives

The exercise of this power by the ASIC, with the consent of the retailers in the market, would be a low cost solution to enable the private electricity market to continue to provide a legitimate hedge function and to prevent artificial and burdensome risk premiums being passed on to electricity consumers.

The ESAA agrees with the view expressed by CAMAC, that a total exemption is "more cost-effective, less intrusive and more consistent with OTC market practices and expectations than reliance on an external insider trading regime." (at paragraph 1.69)

11.2 Other policy options

The ESAA submits that limiting the application of insider trading laws to linked OTC products or disclosable information will not provide sufficient benefit to warrant the greater complexity and uncertainty these hybrid insider trading rules would provide.

In relation to the use of information disclosable under the Code, the ESAA submits that matters such as front running by generators in advance of the PASA are better dealt with by the NEM regulators specifically under the Code, rather then by applying unnecessarily broad insider trading rules.

12. CONCLUSION

Given the nature of the market for electricity hedge contracts in Australia, a prohibition of insider trading in relation to electricity derivatives is inappropriate. The extent of public disclosure of information would be overly onerous on large Corporate trading parties without any benefit to the market, participants in the market or the general public.

The ESAA submits that electricity derivatives should be excluded from the insider trading prohibitions in the *Corporations Act*.

If you have any questions in respect of this submission, please contact Ian Israelsohn on (03) 9670 1017.

Yours faithfully

Keith Orchison
Managing Director

LAW COUNCIL OF AUSTRALIA

Law Council
OF AUSTRALIA

Submission prepared by Corporations Committee Business Law Section

Insider Trading Proposals Paper

December 2002

Insider Trading Proposals Paper

1. Introduction

The Corporations Committee of the Business Law Section of the Law Council of Australia (the "**Committee**") is pleased to have the opportunity to respond to the proposals outlined in CAMAC's Insider Trading Proposals Paper (the "**Proposals Paper**"). The Submission has been endorsed by the Business Law Section but has not been considered by the Council of the Law Council.

In particular, the Committee welcomes the Proposal Paper's discussion of the merits of adjusting the application of insider trading laws to different financial markets. While the Committee supports the general principle of regulatory neutrality, it believes that the extension of insider trading laws to a wider range of markets and financial products by the Financial Services Reform Act (the "**FSR Act**") lacked a sound policy basis and was inappropriate. This issue is addressed further below with the Committee's specific recommendations for action.

While the Committee welcomes the discussion of policy options in this area, it is disappointed that the Proposals Paper does not undertake a more fundamental reassessment of the policy basis for Australia's insider trading laws. In the Committee's submission in response to CAMAC's earlier Discussion Paper on Insider Trading (the "**Discussion Paper**"), we expressed concern that Australia's insider trading laws suffer from significant regulatory overreach and should be confined so that they only operate where there is misuse of privileged access to confidential information. Our previous submission made several suggestions for possible reform in this area, including:

- separating civil and criminal remedies;
- narrowing the criminal offence so that it involves a "person connection" test; and
- adopting the UK model for the civil regime incorporating a "disclosable information" limb.

The Committee acknowledges that each of these proposals may be contentious when viewed in isolation. However, the Committee firmly believes that the current legislative framework extends too far in eliminating incentives for people to use legitimate research to anticipate price changes in the market. This overreach is only ameliorated by the fact that "readily observable matter" is deemed to be generally available information. While the Proposals Paper acknowledges this concern, it does not make any proposals which will address the problem. Indeed, the suggested amendments to the "observable matter" provisions have the potential to extend the overreach even further.

Our detailed comments on the proposals outlined in the Proposals Paper are set out below. However, we urge CAMAC to give further consideration to more fundamental reforms in this area. We also note that some of our comments may need to be altered if the framework of the legislation were changed. For example, we believe that an appropriately formulated "disclosable information" element may have merit in the context of a civil regime along the lines of the UK model, but we do not support it in the context of the current Australian regime.

2. Markets and Products

(a) Introduction

As noted above, the Committee does not believe that the extension of insider trading laws to futures contracts other than equity linked products effected by the FSR Act was soundly based. This extension appears to have reflected a desire to apply uniform laws to financial products on the assumption that all financial products are functionally equivalent. However, in this context, non equity linked futures contracts (such as commodity derivatives) are functionally very different from equity securities and, as a consequence, the application of insider trading laws requires a very different policy analysis. The nature of the markets for these derivatives supports this view.

(b) Nature of the product

It is clear that the fairness and efficiency of equity markets depends upon issuers of equity securities disclosing material information to the market on a timely basis. The major determinants of the price and value of equity securities are the financial performance and prospects of the issuer of those securities and insiders typically have privileged access to price sensitive information which is not generally available. Accordingly, in securities markets, insider trading laws appropriately prevent insiders from trading when they have privileged access to price sensitive information – typically, information in relation to the financial performance or prospects of an issuer of securities or in relation to transactions that may affect the issuer or its securities.

In contrast, markets for financial products such as commodity derivatives operate very differently. The major determinants of the price and value of commodity derivatives are usually factors affecting the market for the underlying commodities. There may be participants in the derivatives market who are better informed about the underlying commodity market than others, but these people stand in a very different position from corporate insiders who may have privileged access to price sensitive information in relation to their company's securities. In these circumstances, the Committee believes it is more appropriate to view the market for the commodity derivative as an extension of the market for the underlying commodity than to view it as functionally equivalent to a securities market.

Accordingly, the Committee recommends that the standards of conduct accepted as being appropriate for the underlying commodity market should largely determine the standards which apply in the derivative market.

(c) Nature of the market

The Committee also believes that nature of most markets for commodity derivatives militates against the application of insider trading laws. The Committee believes that the fairness and efficiency considerations underpinning insider trading laws only justify the application of those laws to anonymous markets whose operations depends upon information being disclosed to market participants on an equal basis. In the context of commodity derivatives, the Committee does not believe that insider trading laws should apply to private transactions or to transactions in over the counter markets where the market participants are typically professional investors who do not expect all market participants to have equal access to information and who are able to regulate their transactions by privately negotiated contracts.

(d) Recommendations

The Committee strongly recommends that the law be amended so that it explicitly identifies the markets and products to which it applies.

The Committee does not believe that a uniform regime can effectively have its operation modified to suit very different markets simply by adding a "disclosable information" element. The scope and interpretation of any "disclosable information" element would be too vague to provide market participants with the certainty they require. In addition, it would not match very well with the inclusion of information which consists of matters of supposition or is otherwise not fit for disclosure

In these circumstances, the Committee recommends that:

- Insider trading laws should not apply to private transactions, over the counter markets or exempt markets.
- Insider trading laws should only apply in relation to transactions on the ASX, other stock exchanges and (subject to the comments below) the SFE and other futures exchanges.[1]
- Insider trading laws should only apply to the financial products to which they applied prior to the FSR Act, ie. securities and equity linked products.
- The suggested "disclosable information" element is not a satisfactory mechanism to achieve this outcome or to accommodate adequately the differences between securities and other financial products in the application of insider trading laws.

3. Disclosable Information Element

The Committee's previous submission in relation to the Discussion Paper recommended the adoption of a "disclosable information" element as a component of a proposed civil regime based on the UK model. However, the Committee does not support the proposed "disclosable information" element in the terms outlined in the Proposal Paper.

As set out in the Proposal Paper, the "disclosable information" element suffers from a number of significant drawbacks. In particular:

- The definition of "disclosable information" does not focus on the identity of the holder of the information. It would apply whether or not the holder had a disclosure obligation.
- The definition of "disclosable information" focuses not only on whether disclosure is required now, but also on whether it may be required "in the future". As a result, all information falling within ASX Listing Rule 3.1 would seem to be "disclosable information" unless it fell within a perpetual carve out. In practice, almost no information can be said to fall within a perpetual carve out.

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[1] There are some transactions which are conducted privately which must be reported to the ASX – "special crossings", for instance. We nonetheless think that if those transactions are conducted between persons with equivalent knowledge, they should be permitted.

The consequence of this is that the proposed test would largely be meaningless. In practice, any information which is "inside information" will almost certainly also be "disclosable information".

Not only would the test be largely meaningless, but it may be harmful. The Proposal Paper suggests that if the disclosable information concept were adopted, this may eliminate the need for the readily observable matter test. In the Committee's view this is wrong and, if acted upon, could result in the current law being extended even further beyond an acceptable scope. In the Committee's view, the deletion of the readily observable matter test would deprive the current law of the only qualification which ameliorates its current overreach.

The Committee therefore recommends that:

- The disclosable information element not be adopted in the terms proposed.
- The readily observable matter test continue to apply.
- In applying the readily observable matter test, the approaches set out in paragraphs 3.14, 3.16, 3.18 and 3.20 of the Proposal Paper be adopted.

4. Carve outs

For the reasons set out in the Committee's previous submission in response to the Discussion Paper, we recommends that carve outs should operate for:

- an entity making a general issue (on the basis that prospectus disclosure rules apply);
- an entity making a private placement (on the basis that the ASIC class orders are complied with);
- a subscriber under a general issue or placement;
- buybacks (on the basis that the company will have disclosed previously material information but shareholders should not be bound by insider trading prohibitions);
- private transactions in exchange tradeable financial products; and
- transactions in unlisted entities.

In this context, the Committee notes that the Advisory Committee has expressed the view that offerees who subscribe for new issues are currently subject to insider trading laws (see paragraphs 2.9 and 2.19 of the Proposal Paper). The Committee questions whether this is a correct statement of the current law.

5. Other Issues

In relation to the proposals outlined in paragraphs 3.2 and 4.2 of the Proposals Paper, the Committee makes the following observations:

- The Committee opposes the proposal to introduce rebuttable presumptions that senior corporate officers are aware of inside information originating within, or known to, their company. As a matter of principle, the Committee opposes the introduction of rebuttable presumptions into legislation that carries serious criminal penalties. The Committee is not aware of there being evidence which demonstrates that practical problems of proof have been experienced to such an extent that any reversal of the burden of proof is warranted. We do not believe that such a significant step should be taken on the basis of anecdotal evidence or assumptions. The Committee's concerns are also influenced by the fact that legislative definitions of "senior company officers" are usually very broad and often apply to a wide range of people who would not typically have access to price sensitive information known to their company.

- The Committee believes that the "own intentions" defence should apply not only to a bidding consortium but also to an individual consortium member who acts with the approval of their consortium. If, as the Advisory Committee appears to accept, market fairness and efficiency is not impaired by a consortium buying ahead of a possible bid, it is very difficult to see how market fairness or efficiency would be impaired to any greater extent by one member of the consortium doing so. Accordingly, the limitation of the defence in this context does not appear to be consistent with the expressed rationale for the legislative regime. There are often circumstances in which not all members of a possible bidding consortium may wish to participate in buying activity and there seems no reason to constrain one consortium member from buying alone when they are free to buy in identical circumstances if their fellow consortium members choose to buy along with them.

- The Committee does not support the extension of compensation claimants beyond the insider's counterparty. We believe this would be punitive, not remedial. In our view, the claims of "contemporaneous traders" could not properly be regarded as claims for "compensation". In our submission, civil remedies for insider trading are more properly viewed as being in the nature of an "account" than "damages" and should be limited accordingly.

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- The Committee believes that insider trading laws should allow directors of takeover target companies to communicate information to a potential white knight if that is done on a basis which precludes the white knight from buying shares before the information becomes generally available. The rationale stated in paragraph 4.52 of the Proposal Paper for the contrary view is that a white knight "buying from an uninformed vendor" has an adverse affect on market fairness, efficiency, integrity and confidence. However, if the defence only permits the **communication** of information when the market is uninformed and does **not permit buying** activity until the information has become generally available, the white knight would not be involved in "buying from an uninformed vendor".

- We support extending the equal information defence to civil proceedings. Indeed, we consider that the law should be changed to permit expressly conveying information to a potential counterparty to a transaction, so long as that person indicates that they will not trade on that information except for the purpose of the dealing with the person who provides the information (therefore, necessarily an off-market transaction) or after it becomes public – noting that this could lead to other disclosure requirements under substantial shareholding provisions.

- We agree with extending s205G by requiring notifications within 2 day – but do not agree with extending the requirement to the 5 highest paid executives – with many companies that changes year on year and it has no necessary nexus with knowledge about the company as a whole.

- We consider that an exemption should apply to underwriters in relation to dealings with sub-underwriters, but do not think that it should be more widely available. Without the exemption relating to sub-underwriters (or amendments like those suggested above which permit "tipping" to those who will only deal with the "tipper" while the information is not public), it may be difficult for underwriters to minimise their risk appropriately.

- We support extending the "chinese walls" defence to procuring.

Otherwise, the Committee is broadly supportive of the proposals set out in paragraphs 3.2 and 4.2 of the Proposals Paper.

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

Dear Mr Kluver,

INSIDER TRADING PROPOSALS PAPER

Macquarie Generation is pleased to comment on CAMAC's Insider Trading Proposals Paper of September 2002. Macquarie Generation is the largest generator on the National Electricity Market and makes extensive use of OTC hedge products to manage our market risk.

Macquarie Generation firmly believes that OTC markets should be exempt from the Insider Trading provisions. We have participated in discussions facilitated by the ESAA and support their recommendation that insider trading laws should not apply to OTC-traded contracts. Whilst we agree with the market principles of the legislation – fairness, efficiency and market competitive neutrality – we believe that these are already a feature of the OTC electricity market.

We give the following specific reasons why electricity OTC markets should not be captured by the Insider Trading provisions:

1. *Nature of Market participants* – There are no retail participants. All parties have teams of well informed and experienced traders backed up by sophisticated IT systems. The market is also served by a number of agencies that help disseminate data and information. For example:

   - Energy Bank Link (EBL) – daily market happenings, opinions and reported prices and volumes traded.

   - Reuters – Brokers posting bid and offer prices as well as general financial markets news.

   - Australian Financial Markets Association (AFMA) – encourage use of standard contract documentation and facilitate the publication of a market revaluation curve.

   - NEMMCO – future generating plant availability is published in the PASA.

Mr John Kluver, Executive Director
Corporations and Markets Advisory Committee

2. *Defining Price Sensitive information* – We believe that in the OTC electricity markets, it will be difficult to define price sensitive information that should be disclosed. At Macquarie Generation, we regularly prepare budgets, plans and strategies for the marketing and production arms of our business. These are revised and refined over a period of time. This information could be viewed as price sensitive, however we regard such information as "commercial in confidence" and being required to make it available to other market participants would commercially disadvantage us. There is also no centralised procedure or platform for disseminating this information.

3. *Current remedies exist* – Although electricity contracts are based upon standard documentation, deals can be structured to meet the specific needs of the parties. Disclosure obligations can be included in specific contracts. Parties also can rely on statutory and common law protections against misrepresentations or false and misleading statements.

4. *Enforceability of Contracts* – The new Insider Trading provisions may encourage litigation, where the ulterior motive of one of the parties is to frustrate or force renegotiation of a contract that has become "out of the money" for them. Such additional legal risk adds another layer of uncertainty to OTC contracting.

5. *Compliance Cost* – These may become onerous. Standard contractual terms may no longer be sufficient and a legal opinion may be required depending on the circumstances of each deal.

RECOMMENDATION

Of the policy options considered by CAMAC, Macquarie Generation recommends, in order of preference, that:

(a) The current insider trading laws applicable to OTC-traded financial products should be repealed.

(b) If not repealed, the "disclosable information" option should be adopted on the proviso that market participants are consulted in determining the price sensitive information that each particular industry would expect to be disclosed. We consider that this option would still create significant difficulties in its practical application.

All of Macquarie Generation's output is sold into the National Electricity Market that has a history of price uncertainty and high volatility. We are heavily reliant on a robust and efficient OTC market to achieve predictable revenues and corporate profit targets. We believe that the Insider Trading provisions that now apply have the potential to seriously effect our ability to manage risk in this market.

Yours faithfully

G V EVERY-BURNS
CHIEF EXECUTIVE
AND MANAGING DIRECTOR

Shaun Ansell

24/10/2002 06:11 PM

To: john
cc:
Fax to:
Subject: Insic

John

Ive just finished reading the insider trading report. Im not authorised to proffer any comments on behalf of ASIC, so Im simply providing private comments on 2 aspects of the report that I feel could be further illuminated.

Reporting by Directors

First, in relation to s205G (para 3.3), prior to the FSR Act, the view was held that trading in company issued options prior to exercise was not required to be disclosed. This stems from the long held view that company issued options were not securities under the previous s92 as they were not units of shares the shares being unissued.

Although company issued options are now (post FSR) securities under the definition in s761A (for the purposes of Ch7), it is not apparent to me that the definition in s92 has cured this defect. Although the definition excludes derivatives, and in turn it is noted that company issued options are not within the definition of "derivative", Im not sure this brings company options into the definition because they are still not units of shares. In fact, the definition in s761A seems to acknowledge that company issued options do not amount to such.

Time of ASX Transactions

Second, in relation to **Mt Kersey** (para 3.42), I attach a copy of a newsletter prepared by SMARTS, an organisation associated with Professor Mike Aitken-see www.smarts.com.au. In my view, this synopsis usefully discusses the mischief of the Mt Kersey case. Essentially, although the legal reasoning underlying that case appears to be technically correct by reference to the question of when a contract is formed on ASX, its mischief is that traders with inside information can place orders on SEATS and providing those orders do not trade, there is no contravention. The mischief of that practice is that those orders gain time priority on SEATs and that destroys the integrity of the market. The paper does not seem to discuss the issue of time priority, and thus the ultimate conclusion in para 3.46 that noone suffers detriment until an offer is accepted is flawed because persons who would otherwise have had time priority do not when a person with inside information is permitted to place an order on SEATs providing the order does not trade.

Moreover, in my view, it is not anomalous that a person can be liable where no trading takes place (para 3.44). As I apprehend it, communication is contrary to s1043A, whether or not trading takes place.

Further, you might recall that in the **Nomura** case, Nomura argued that there could be nothing misleading about Nomura's conduct until its strategy was put in place. Save for the two self-trades which actually occurred, the strategy was never implemented. Section 998(1) could not be read as covering mere attempts. Sackville J responded that

Nomura, in placing the Bid Basket and giving instructions for the March Sale Orders, engaged in conduct intended to create a false or misleading appearance of active trading on the ASX in illiquid securities held by it on 29 March 1996. It also engaged in conduct intended to create a false or misleading appearance with respect to the price of illiquid securities held by it on the same day. Nomura's conduct therefore contravened the second limb of s 998(1) of the *Corporations Law*. This aspect of Nomura was upheld by the NSW Court of Criminal Appeal in **OHalloran.**

By parity of reasoning, it might be argued that where an insider places an order on SEATs and gains time priority (with the benefit of inside information), that person is contravening s1041B as traders who place orders after that person act on the assumption that that person is acting on the basis of all of the information in the market, when in fact they are privy to inside information. Those cases also demonstrate that civil/criminal consequences can flow, whether or not a trade is effected.

Issue 7- Mt. Kersey Mining Case

This issue of Discovery examines a recent insider trading case in Australia. The case was dismissed by the judge, however, it raises a number of interesting issues for securities market organisers and regulators.

Facts of the Case

The facts of the case are obtained from a number of Australian Financial Review articles that appeared on 17, 18 and 20 November 1999.

On 21 November, 1995 the Australian newspapers reported what was believed to be the highest grade nickel discovery ever. The discovery was made in Kalgoorlie, Western Australia. The discovery was important because it was made on a tenement next to one owned by Australian listed company Mt Kersey Mining.

News of the discovery, however, was far from new. A private company, Mining Project Investors (“MPI”), made the discovery in May 1995. However, as a private company, MPI was under no obligation to report this information publicly. Therefore the information remained generally unavailable.

Prior to the release of the information, Alan Evans, Finance Director of MPI formulated a plan to purchase stock in Mt Kersey shortly after the information was released to the public. The plan involved briefing a journalist at 14:00 on 20 November followed by a news release that was to be faxed to journalists, investment advisors and people associated with MPI. Evans also instructed a broker, at a Melbourne stock broking house, to purchase 166,000 shares in Mt Kersey after 14:00 on the day of the announcement.

However, the plan did not run smoothly. The journalist arrived 30 minutes late and as a result the press release was not faxed until 14:49. Unaware of these delays, Evans called the broker to request that he delay the purchases until after 14:30. He reportedly changed the timing of the purchases in order to allow 30 minutes for the information to be disseminated to the market.

The broker then began purchasing stock on behalf of Evans at 14:31, prior to the dissemination of the information to the Australian Stock Exchange (ASX) or any other party. At 14:34, the broker announced the details of the MPI nickel find to other dealers at his firm. This resulted in significant buying from other clients of the broking house. At the close of trading the price of Mt Kersey had risen by 29 percent and the daily turnover was four times higher than average. This unusual trading behaviour precipitated a lengthy investigation by the Australian Securities and Investment Commission (ASIC). This investigation culminated in charges being laid against Evans and the dealer. The ASIC viewed this as a test case to establish the boundaries of Australia’s insider trading laws

Importance of the Case

The Mt Kersey case was important for a number of reasons. First, the ASIC hoped to establish that a person with no legal relationship to the company could be considered to be an insider when in possession of price sensitive information, which was not generally available. This would have made the scope of Australia’s insider trading laws wider than most other jurisdictions. Many jurisdictions still require that a duty of care or fiduciary relationship exist between the trader and the company in which they are trading.

Second, the dealer was the first person to be charged with insider trading without having personally profited from the activity.

Third, Evans was the first person to be charged with insider trading while acting as a director of a company which was not required by law to announce their results to either the ASIC or ASX. The case offered an opportunity to test whether insider trading can take place when non-public information about a private company could affect the price of a listed company.

Finally, the fact that Evans intended to wait for 30 minutes after the release of the information before he traded raises a number of additional issues which could have tested by this case. Recall from Discovery 6 that the Australian insider trading provisions require that a person trades on the basis of information that is not generally available. It also requires that parties do not trade until a "reasonable period for it to be disseminated" among "persons who commonly invest" in the stock has passed. None of these terms have been clearly defined in the law and will remain ambiguous until tested. Perhaps 30 minutes was sufficient time for the information to be disseminated to persons who commonly invest in Mt Kersey. If this is the case, then Evans and the dealer had no case to answer

Outcome of the Case

The Mt Kersey Mining case had the potential to test the boundaries of insider trading laws in Australia. However, it failed to do this as it was dismissed on a technicality.

The judge dismissed the case because the prosecution had based the case on the wrong time.

The prosecution took the view that there was an agreement to buy shares when the client placed the order with the broker. However, the defence argued that there was no agreement until the order had actually transacted on the exchange. Despite the fact that this view conflicts with the view of most brokers, the judge agreed with the defence. Further, he ruled that the defence would be prejudiced because the prosecution had based the case on the earlier time and therefore dismissed the case.

Implications

While this decision prohibited the ASIC from testing the boundaries of the insider trading laws, it raised a number of new issues.

First, it suggests the need for clarity in the definition of an agreement to buy shares. The definition accepted by the judge in this case raises new issues for insider trading cases. If an agreement is not made until the transaction takes place, insiders are legitimately able to place orders into the order book, in order to gain time priority[1], before the information becomes generally available. Therefore, they are able to take advantage of their inside information by ensuring that their orders will be executed first, without risking prosecution for insider trading. Clearly, this is not a desirable outcome.

Second, as discussed in Discovery 6, it identifies the need for training of judges to ensure that they are aware of industry practices and behaviour. The definition of an agreement to buy shares accepted by the judge in this case is clearly inconsistent with the view held by industry.

Third, the case also raises questions about whether a judge should have allowed the jury to make a judgement on the facts of the case, despite the procedural problems.

Fourth, it suggests that the defence should be required to outline their approach at the outset of the trial to prevent such procedural errors. In this case, the defence waited until five weeks into the trial before debating the definition of an agreement to trade. Had this issue been identified earlier, the prosecution could have amended its case accordingly.

Conclusion

Finally, questions have been asked as to whether trial procedures should be changed to allow for a retrial if an appeal court finds that the trial judge misinterpreted the law in cases such as this.

Footnote

1. Time priority means that orders at the same price which are place earlier will be executed prior to those which are placed later.

Accordingly, I do not think that an insider should be able to either place an order or trade when in possession of inside information, as both affect market integrity. Placing an order disadvantages other traders in terms of time priority, whilst trading disadvantages the counterparty. At most, instructions could be given to a broker by an insider, as noone is detrimentally affected by that act. However, that may well constitute communication contrary to s1043A(2) as well as manipulation contrary to s1041B.

Please call me on (07) 3867 4757 if you have any queries.

Shaun

John,

further to my earlier comments, you may have seen the front page article in the Australian today "Executive option scams exposed".

This makes the point, inter alia, that option deals which dispose of the economic or legal interest prior to exercise need not be disclosed under s205G.

In my view, Professor Fels is correct in suggesting the failure to disclose is misleading-rather than the Trade Practices Act, it is contrary to s995 or post FSR, s1041H of the Corporations Act.

Although s205G technically does not require disclosure, the case GPG v GIO [2001] FCA 1761 demonstrates that even where the continuous disclosure laws (to which s205G is analogous) do not require disclosure, there may be a civil contravention of those sections where there is a reasonable expectation that the information would be disclosed.

SA

Executives secretly cash in bonuses

By Michael West
November 22, 2002

AUSTRALIA'S business leaders have been cashing in their lavish incentive payments – without telling their shareholders – under loopholes in the stock exchange rules.

A document from leading investment bank UBS Warburg – obtained by *The Australian* – shows how corporate executives can reap millions of dollars from their shares and option plans, while giving the appearance there have been no changes to their bonus deals.

These payment arrangements are achieved through complex financial transactions sometimes called protection schemes.

But the Australian Stock Exchange said such schemes were misleading and against the spirit of good corporate governance.

"They are potentially misleading, inasmuch as senior executives have exposure to upside or downside in the stock and, as it turns out, that executive might be quarantined from any upside or downside," ASX spokesman Gervaise Green told *The Australian*.

Under the schemes, an executive with employee share options awarded by the company will pay an investment bank to structure a mix of "call options", "collars", "forwards" and "equity swaps" over the company stock to lock in the value of the share price at a certain point and protect capital gains, while retaining legal ownership of the stock.

The executive maintains voting rights and dividends but defers legal disposal of the shares.

The scheme means executives are protected from share price falls and have less incentive to drive the share price up, as they get little reward for a higher share price.

In the case of One.Tel, executives could have locked in the value of their options regardless of the performance of the shares and the company itself.

Australian Competition and Consumer Commission chairman Allan Fels said last night the scheme may breach the Trade Practices Act.

``There could be issues under the misleading and deceptive conduct provisions of the Trade Practices Act,'' he said. ``The fact that there are no active forms of misleading behaviour is one thing, but silence can constitute misleading conduct.''

Stock and stock option plans are supposed to give executives incentives to perform and therefore align their interests with those of their company's shareholders. If the share price goes up, the executives are rewarded and shareholders get a gain on their investment. Under Australian Stock Exchange disclosure laws, executives are required to inform the exchange and their shareholders when they buy or sell their employee stock.

However, the UBS document _ and similar schemes are offered by Macquarie Bank, Salomon Smith Barney, JB Were and other leading banks _ shows how corporate chiefs can capture the value of their incentive bonuses without necessarily telling the ASX, while maintaining legal ownership of the assets. The Australian surveyed the top 18 companies on the ASX _ the top 20 minus Telstra, which remains 50.1 per cent-owned by the Government, and Telecom New Zealand.

Of those 18 companies, just one, Westfield Holdings, conceded that its executives had participated in protection deals, and only one, National Australia Bank, ruled out any involvement in protection schemes by its top executives.

Foster's, Westpac, Woodside, Coles Myer, AMP, Qantas, St George Bank, News Corporation (parent of News Limited, publisher of The Australian), Commonwealth Bank, BHP, Singtel (Optus), Woolworths, ANZ, Rio Tinto, Wesfarmers and WMC Resources all declined to rule out that their top brass had cashed in stock incentives at some time in the past five years. ASX chairman Richard Humphrey said: ``The spirit of the rules is about being transparent and about disclosure, and these schemes would appear to work against that philosophy.

``There seems little point in aligning the management of directors' interests with those of the shareholders if that nexus can be quietly broken immediately afterwards.''

8 November 2002

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

By Email: john.kluver@camac.gov.au

Dear John

TXU Comments on the CAMAC Insider Trading Proposals Paper dated September 2002

I apologise for this late submission and hope you are still in a position to take account of our views.

TXU has a large physical presence in the National Electricity Market through its retail, generation and regulated networks activities. It is also a major participant in the OTC markets of electricity hedging instruments. We have conducted numerous trades with most, if not all, the participants of these markets. We would describe ourselves, and all our trading counterparties as "sophisticated" participants of the secondary market.

TXU wishes to lend support to the views expressed by Snowy Hydro Ltd and the Electricity Supply Association of Australia in their submissions to you regarding the Insider Trading Proposals Paper.

TXU considers that the OTC electricity market and electricity futures exchanges should be exempted from insider trading laws. The benefits of insider trading bans has relevance to equity markets where enterprises are seeking capital from a broad community of unsophisticated investors. The electricity derivative market is primarily concerned with the hedging of price risks between sophisticated physical participants.

Insider trading laws are likely to harm these markets through

- an inefficient derivatives market caused by enforced trading delays,
- clashes with the confidentiality requirements of instruments with a physical influence such as demand management contracts and power purchase agreements,
- confusion regarding the practical definition of inside information ,
- general costs of compliance.

TXU concurs that the practical examples presented in the snowy hydro submission show the application of insider trading laws in our industry would be unworkable. TXU currently optimises its physical and contractual portfolios simultaneously considering the current markets for each, but an insider trading regime anticipates that physical decisions always precede and drives derivative trading decisions. Contrarily, TXU's physical decisions are more often than not efficiently driven by the outcomes of the derivatives market. For example, should our traders observe derivatives markets to be weaker than our view of fair value, we may buy up contracts and then subsequently take advantage of the resulting length to plan generator maintenance or acquire more retail customers.

Such rational behaviour is questionable under an insider trading regime and exposes us to litigious claims from counterparties alleging we mislead them by not accurately forecasting our physical behaviour at the time of trade.

We also note the tension between trading markets regulators' desires to enforce more disclosure, and competition regulators' desires for more opaque markets to diminish market power. The ACCC has on several occasions questioned any role for physical market forecasting and has recently suggested NECA propose code changes to limit the release of NEM physical market data. Similar issues are raised in relation to the Texas electricity market that has little public information release. Regulators are concerned that should physical information be provided to the market (such as upcoming generation outages) there is an opportunity for competitors to exploit their resulting increased market power by raising prices on the derivative market.

We hope these comments are useful to your deliberations. For any questions please contact me on (03) 8628 1280.

Regards,

(signed)

Ben Skinner
Regulatory Manager, Electricity Trading