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.