

REGULATION OF INSIDER TRADING: THE AUSTRALIAN EXPERIENCE

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I. INSIDER TRADING — THE POLICY BASIS OF A REGULATORY FRAMEWORK

A. *Insider Trading Defined*

“Insider trading” is a term used to describe dealings in the securities of a company by persons who are closely associated with the company and who are, as a result of that association, in possession of confidential, price-sensitive information concerning the company’s securities. The information is material and price-sensitive in the sense that it would, if known, be likely to influence the decision of the person with whom the insider is dealing to buy, sell or retain shares in the company as the case may be. The insider is motivated to trade in this manner in order to gain profit or avoid a loss before the information is eventually disclosed to other members of the company or the investing public.

Notwithstanding respectable arguments to the contrary, most countries agree that insider trading is undesirable and should be regulated by law. This article is concerned in the first instance to consider the underlying goals and objectives of any regulatory framework in this area. We shall then proceed to consider the common law and statutory enactments presently operating in the Australian jurisdictions with a view to determining, whether the regulatory framework is achieving the necessary goals and objectives. Finally the article will address future directions for insider trading regulation in Australia particularly in light of the recently released Issues Paper prepared by Professor Philip Anisman for the Working Party on Insider Trading of the National Companies and Securities Commission (“NCSC”) and recent announcements from the Commission that it expects to take at least one insider trading case to court in late 1987 with further cases coming to trial early in 1988.

B. *The Policy Basis of a Regulatory Framework*

In any attempt to regulate the practice of insider trading there will need to be at the outset a clear appreciation of the reasons for regulation. Any uncertainty or lack of conviction will be reflected in the inefficiency of enforcement of the regulatory framework. One commentator¹ has recognized this important first step when he states:

“The possible regulation of insider dealing has received considerable attention in the last two years and yet the proposals for such regulation have shown signs of inadequacy . . . It would seem that one of the reasons for the inadequacy is a failure to identify clearly the policy basis for the regulation of insider dealing, which in turn reflects on uncertainty as to the justification for the prescription of the practice at all”.

¹ Robin G.A. White “Towards a Policy Basis for the Regulation of Insider Trading”, 90 LQR 494.

It is common to find in the literature broad appeals to fairness and commercial morality as the justification for the prohibition of insider trading. For instance², “it is contrary to good business ethics that a man holding a position of trust in a company should use confidential information for his personal benefit — and good business ethics ought to be reinforced by legal sanctions”. But in business, taking advantage of the less informed position of other parties is ubiquitous and in the absence of misrepresentation or fraud rarely prohibited. Any justification for the regulation of insider trading will need to go beyond broad appeals to good business ethics. In considering more closely the substantive reasons for any regulatory framework in this area several propositions may be advanced. The first and most commonly offered is that regulation is intended to achieve equality of bargaining position between insiders and outsiders. Here any notion of unfairness is not attributable to the mere fact that the insider possesses more information than an outsider for he may have acquired such information through his diligence and zeal. Rather the concern here is with such information being acquired by virtue of the insider’s position with the company and where such information is unavailable to an outsider no matter what degree of diligence or zeal the outsider possesses or brings to bear when reviewing the state of his investment.

Avoidance of such information disparity can be achieved if the insider is required to either disclose the relevant information before trading or abstain from trading altogether (where such disclosure is not possible). We shall observe later that the Australian framework is based on such a disclose-or-abstain premise providing as it does that an insider shall not deal in any securities where he is in possession of material confidential price-sensitive information, although such insider will not be in contravention of such prohibition where he can satisfy the court that the other party to the transaction knew of the information before entering into the transaction (see sections 128(1), (10) Securities Industry Code).

A further objective of regulation of insider trading has been described as “market efficiency”. Farrar and Russell³ have clearly expressed the consequences of insider trading for market efficiency in the following terms:

“The efficiency argument looks to the effect on the market of the non-disclosure and self-dealing by the insider . . . Investors should be able to identify those companies where their capital is most needed and will most profitably be used. This enables resources to be allocated efficiently and not ‘wasted’ in companies which are going into decline. An efficient stock market therefore is necessary to ensure this allocation of capital. If however there is information available of a price-sensitive nature which is not disclosed and on the basis of which some people only are trading, then the market is being distorted. The price at which those shares are being traded is an artificial one. When this fact subsequently becomes apparent public confidence in the stock market is diminished. Investors are generally averse to risk. If it therefore appears that investing in the stock market is becoming more of a gamble because of self-dealing then they will pull out and look to invest elsewhere, usually through the financial institutions”.

² Justice, *Insider Trading*, (1972), p. 12.

³ J.H. Farrar and M.W. Russell, *Company Law and Securities Regulation in New Zealand*, Butterworths (N.Z.), 1985, 251.

In similar terms Rider⁴ states:

“Insider trading lowers the integrity of a market and thus the confidence that is reposed in it as a fair, efficient and economic allocator of scarce capital resources . . . It is therefore submitted that the primary justification for anti-insider trading regulation must be the protection and promotion of investor confidence in both the integrity and efficiency of the securities market”.

Another reason for regulation of insider trading arises from a recognition that the insider acquired the relevant information in a fiduciary capacity, knowing it was intended for a company purpose and not for personal use and benefit. Regulation on this premise is aimed at having the insider account to the company for any profits gained through and in breach of his fiduciary position with the company.

Given the policy justification for regulation of insider trading any enactment in the area will be required to address the question of compensation and penalties. Punishment of the wrongdoer, the disgorgement of unfair gains, the compensation of injured parties, will be important aspects of a regulatory scheme and will largely depend upon the law-maker's perception of the wrongful nature of the practice. Ford⁵ recognizes the decisions which will need to be made in this respect when he states:

“A further question is whether an offender should be liable to pay not only a penalty to the state but also to account for any gain and, if so, whether that gain should be accounted for to the company or whether it should be paid by way of compensation to the other party to the dealing. If the latter is to be the case, is the object of the legislation to deter insider-dealers, or is it thought that the other party deserves compensation.”

It can be seen that any attempt to regulate insider trading will be confronted with a diversity of interests to be protected with decisions to be made as to the most effective means of control and the appropriate compensation and penalties to be imposed. Notions of fiduciary impropriety will stand alongside notions of market integrity and equality of bargaining positions. The regulatory framework will need to recognise the relationship of insiders to the company and also be cognizant of the relationship of insiders to company shareholders and other outsiders. Essentially these matters can be condensed to the following questions:

- what is the nature of inside information;
- who is an insider;
- what prohibitions on dealings should be imposed; and
- what compensation, penalties and defences should be provided for?

Before considering the manner in which the Australian law-makers have addressed these matters it is appropriate to mention that some commentators

⁴ Barry A.K. Rider, *Insider Trading*, Jordan and Sons Ltd., 1983, 5.

⁵ H.A.J. Ford, *Principles of Company Law*, Butterworths, 1986, 716.

have argued that regulation of insider trading is undesirable. The principal proponent of deregulation has been Professor Henry Manne whose work "*Insider Trading and the Stock Market*"⁶ remains the most widely quoted statement of the case. Although it is beyond the scope of this article to evaluate Manne's contentions it will be useful to briefly state his principal arguments in support of unrestrained insider trading.

Manne argues that an efficient securities market is one which properly reflects the variations in corporate fortunes. He suggests that the insider knowing of information which will have the effect of setting the correct level of share prices, positively assists in bringing about a true state of affairs in what has hitherto been an ill-informed market. Irrespective of the merit of this contention Professor Manne has not, however, addressed the competing issues of equality of bargaining position and the fiduciary position of the insider in the company.

Professor Manne also argues that the profits accruing to the insider are a legitimate, indeed the only, method of rewarding entrepreneurial enterprise, skill and ability. This argument has been widely criticised as failing to recognise that an insider can profit from a decrease in the company's share prices as well as an increase and personal profit in those circumstances is clearly unrelated to entrepreneurial skills. Moreover the temptation of profit might actually encourage the insider to act against the company's best interests. For instance the insider might delay disclosure longer than is desirable or may continually structure corporate transactions in a manner that increases the number of occasions for insider trading and this may become so notorious as to reflect on investors' willingness to invest in the company's securities to the eventual detriment of the company. For reasons such as these unregulated insider trading should not be seen as the best available reward for entrepreneurial effort. Alternative compensation schemes such as carefully allocated profit sharing or share incentive schemes will achieve the same result. In perceiving insider trading as an appropriate means of rewarding entrepreneurial enterprise the words of the English novelist, Anthony Trollope appear appropriate when he, in describing market practices in the City of London in 1872 warned of a type of dishonesty that "is so magnificent in its proportions, so rampant and so splendid that those who play it will be taught to feel that dishonesty, if it can become splendid, will cease to be abominable".

II. THE CURRENT AUSTRALIAN POSITION

A. Common Law Restriction

The relevant principles of the common law will be considered in a summary manner for, unlike countries such as New Zealand where the area remains significantly regulated by common law, Australia has come to rely principally upon statutory enactment in this area. Notwithstanding this, the statutory provisions in the area will be better appreciated with some understanding of the common law position.

It has long been a principle of common law that if a director or other officer of a company makes use of confidential information acquired as a consequence of his office for his own personal gain he thereby breaches his fiduciary duty to the company and is liable to account to the company for any profit made.⁷ This obligation not to profit from a position of trust is

⁶ H.G. Manne, *Insider Trading and the Stock Market*, The Free Press, 1966.

⁷ See *Green and Clara Pty. Ltd v Bestobell Industries Pty Ltd.* (1982) 1 ACLC 1.

in substance a manifestation of the obligation to avoid a conflict arising between duty and one's personal interest.

There is, however, an immediate difficulty in applying such conflict of duty and interest principles to insider trading particularly in cases where the insider is buying in shares from outsiders. As one commentator⁸ states, "it will be difficult for the courts to rely on the equitable prohibition against fiduciaries becoming involved in conflict of interest situations for as the company cannot buy its own shares⁹, the insider can never be put in the position of having to decide whether the shares should be purchased on behalf of the company or himself." Essentially, so it may be argued, insider trading generally affects the position of other shareholders and not the company which will have little concern in the day-to-day trading in its shares.

Notwithstanding such argument persuasive authority exists which suggests that the misuse of confidential information is in itself a sufficient justification for a cause of action vesting in the company, even although the company has not suffered loss or could not have made the profit derived by the insider.¹⁰ Moreover it is difficult to refute the argument (emanating from the U.S. case law) that the company ought to have a cause of action in such circumstances for it will experience detrimental consequences as a result of insider trading. *Diamond v. Oreamuno*¹¹ gives the best expression of this philosophy when the court states:

"Although the corporation may have little concern with the day-to-day transactions in its shares, it has a great interest in maintaining a reputation of integrity, an image of probity for its management, and in ensuring the continued public acceptance and marketability of its stock. When officers and directors abuse their position in order to gain personal profits, the effect may be to cast a cloud on the corporation's name, injure stockholder relations and undermine public regard for the corporation's securities."

Given the potential for such detriment or loss being suffered by the company a flexible development of equitable doctrine is warranted. Recovery by the company, however, will not of course benefit the other party to the transaction unless he remains a shareholder and unless the sum recovered is such as to result in an overall appreciation in the value of the company's securities. The insider will, however, be deprived of his gains. Ironically should the insider be a majority shareholder most of the amount recovered would revert to the insider qua shareholder. It follows from this that the question whether at common law the insider's duty extends to individual members (outsiders) with whom he has dealt so as to result in a cause of action vesting in the latter is of considerable significance. (Assuming of course that such members can identify the insider as being a party to the dealings. Such will only be possible in the case of a small proprietary company, for as we shall see later, in an organized securities market involving publicly traded securities anonymity of traders results.)

⁸ E.J. Wright "Insider Trading in Corporate Securities — Can we Learn from America?", [1971] 4 NZULR 209, 224.

⁹ See s. 129(1), Companies (SA) Code.

¹⁰ See *Reading v A.-G.* [1951] AC 507.

¹¹ 248 N.E. (2d) 910 at 912 (1969).

Percival v. Wright is widely acknowledged as establishing the principle that although a director has a fiduciary duty to the company, such duty does not extend to its individual shareholders. That case concerned directors acquiring shares from a shareholder at a time when the directors were in possession of confidential information about the company which had significance for the value of those shares. Swinfen Eady J. reasoned:

"I am . . . of opinion that the purchasing directors were under no obligation to disclose to their vendor shareholder [confidential price-sensitive information]. The contrary view would place directors in a most invidious position as they could not buy or sell shares without disclosing [such information], a premature disclosure of which might well be against the best interests of the company . . ."

Interestingly it did not occur to the court that it may be desirable for the directors to abstain altogether from trading in such circumstances. At the turn of the century directors, so it would appear, had a right to deal in the securities of their companies and such right, coupled with the obligation to the company of non-disclosure of confidential company information, outweighed any argument to the effect that abstention from trading was the proper requirement in such cases. Given the right of the insider to deal in his company's securities and his duty of non-disclosure the outsider was left without remedy.

It has been acknowledged that in certain circumstances a fiduciary relationship between a director and a shareholder could arise. In *Allen v. Hyatt*¹³ for example the directors of a target company were held to have purchased shares from other shareholders in particular circumstances which constituted them as agents of the shareholders for the purpose of negotiating a take-over bid. On this basis the shareholders were held to be entitled to recover on a pro rata basis the profit accruing to the directors from the subsequent sale of the shares.

Despite the willingness of courts in other jurisdictions to depart from the *Percival v. Wright* doctrine¹⁴, the Australian jurisdictions have on occasions continued to support that authority. For instance in the Western Australia case *Esplanade Developments Pty. Ltd v. Divine Holdings Pty. Ltd.*¹⁵ (involving directors acquiring shareholders interests immediately preceding a take-over) Brinsden J. states: "It can be agreed immediately that the directors of [the company] owe a fiduciary duty to it. That duty is owed to the company and to the company alone. The directors owe no duty to individual members as such". On the other hand in a more recent case *Hooker v. Baring Bros. Halkerston*¹⁶ Young J was inclined to observe: "If *Percival v. Wright* were correct there were very great problems indeed in such persons recovering what a lay observer might consider was their just rights. Of course since then *Percival v. Wright* has virtually been discarded by more modern thinking."

And so in the absence of a special agency relationship of the kind recognised

¹² [1902] 2 Ch 421 at 426.

¹³ (1914) 30 TLR 444.

¹⁴ See *Coleman v Myers* [1977] 2 NZLR 225; *Strong v Repide* 213 U.S. 419 (1909).

¹⁵ (1980) CLC-CCH 40-637.

¹⁶ (1986) 10 ACLR 462 at 463.

in *Allen v. Hyatt*, there remains an argument to the effect that a director (or other company officer) who by reason of his position has acquired certain price-sensitive information concerning the company or its securities will incur no liability at common law to the other party with whom he trades when he fails to disclose that information. It is not unexpected that the common law in some overseas jurisdictions has resiled from this position.¹⁴ In Australia the matter has been left to statutory enactment to which we now turn.

B. *Statutory Restrictions*

The relevant provisions governing insider trading in the Australian States are found in section 229 of the various Companies Codes and sections 128-130 of the Securities Industry Code.

C. *Companies Code* Insider trading most often involves company directors, officers and employees, for of course it is they who have most access to price-sensitive confidential information affecting the company or its securities. Essentially insider trading is but one example of such insiders using to their advantage confidential information of the company, and for this reason is seen to be caught by those provisions of the Code which are concerned with the misuse of a company's confidential information.

Section 229(3) of the Companies Code provides as follows:

“An *officer or employee* of a corporation or a former officer or employee of a corporation shall not make improper use of information acquired by virtue of his position as such an officer or employee to gain, directly or indirectly, an advantage for himself or for any other person or to cause detriment to the corporation”. (Italics supplied)

An “officer” is defined in section 229(5) as meaning a director, secretary and executive officer (the latter being further defined in section 5).

A breach of section 229(3) renders the officer or employee liable to a penalty of \$20,000 or imprisonment for 5 years or both.

Section 229(6) empowers the court to order a convicted person to pay compensation (of such amount as the court specifies) to the company if it has suffered loss or damage.

Also section 229(7) provides the company with the right to recover the amount of any profit made by the officer or employee as a result of the contravention or, where the company has suffered loss, to recover an amount equal to that loss; such right exists irrespective of whether the officer or employee has been convicted of an offence under section 229(3).

Section 229(8) prevents double recovery where proceedings have also been instituted under section 128 of the Securities Industry Code. The effect of this provision is to ensure that any amount which an officer or employee is liable to pay to the company under section 229 is reduced by an amount which he has already been ordered to pay under section 130 of the Securities Industry Code.

It will be observed that section 229 is solely concerned with the duty and liability of officers and employees to the company. The section does not purport to remedy the position of the person who has dealt with the insider. To that extent the provision does not change the common law position.

To date there have been no reported decisions under section 229(3) although

the predecessor of that provision (section 124(2) Companies Act 1961) was considered by the Victorian Supreme Court in *Waldron v. Green*.¹⁷

Green was a director of Endeavour Oil N.L. and was also a director and major shareholder of a family company Gurello Pty. Ltd. which owned shares in Endeavour Oil N.L. Green learned at a meeting of directors of Endeavour Oil N.L. that a call upon the shares of that company was imminent. Green then arranged for his family company to sell 100,000 of the 180,000 shares it held in Endeavour Oil at 14c and 15 c per share. Soon afterwards Endeavour Oil N.L. announced a 5c per share call and the price of the shares on the stock exchange fell to 11c per share. In proceedings instituted against Green by the Corporate Affairs Commission it was alleged that he had made improper use of information acquired by his virtue of his position as an officer of Endeavour Oil N.L. to gain an advantage for his family company and indirectly an advantage for himself.

The Commission failed in its action against Green. McInerney J, although holding that Green had possessed inside information of the kind covered by the section, held that the Commission had failed to establish that there had been any use of that information. There being no admission that the sales were induced by the information acquired, the Commission was obliged to rely on an inference or circumstantial evidence. Green argued that Gurello Pty Ltd. had a "liquidity problem" and was anxious to realize on non-income producing shares. McInerney J concluded that "the inference that the respondent did use the information is, in my view, of no more than equal degree of probability with the inference that he did not. Consequently, in my view, the prosecution failed to make out a case."

Because of the statutory offence involved the decision can no doubt be seen as an example of the courts' inclination to interpret criminal statutes narrowly and to require strict proof of an offence. Nonetheless if an explanation of the kind offered by Green was seen as plausible and sufficient to defeat the section then the future operation of that provision is not promising. The Commission after this decision will be reluctant to commit scarce prosecution resources except in the most obvious of cases where the insider has virtually no explanation at all for his insider dealing. It has been suggested that, in so far as insider trading is involved, an officer may not be guilty of an "improper use of information acquired" under sub-section 229(3). Skoyles¹⁸ for instance suggests that in view of *Percival v. Wright* it will be difficult to argue that information has been "improperly" used when there is no duty to disclose it. However, Skoyles' reference to *Percival v. Wright* does not appear to be at all relevant for the purposes of this provision. That case is concerned with the liability of the officer to outsiders. This provision is concerned with the liability of the officer to the company. Any culpable conduct under section 229 arises from the duty of the officer to his company and not to outsiders. If it can be shown that insider trading constitutes *in so far as the company is concerned*, an improper use of information by the officers, then there will be a contravention of section 229(3) and a right of recovery by the company of profit gained by the insider.

Although, as we have seen, there is some doubt at common law that insider

¹⁷ (1977-78) CLC-CCH 29-728.

¹⁸ Kathryn Skoyles, "The Fiduciary Basis of Insider Trading Liability: Dirks Down Under?" (1984) 2 C & SLJ 13.

trading constitutes such a breach of duty owed to the company (because, for example, the company cannot deal in its own shares), the better opinion is that it does amount to such a breach. There is sufficient judicial recognition that the use of confidential information for the purposes of insider trading is a breach of fiduciary duty owed to the company, irrespective of whether the company itself could have made the profits involved. On this point it is worthwhile noting that *Waldron v. Green* saw no suggestion that use of company information for insider trading would not be an improper use of information by the officer. That case simply turned on the fact that the dealings of the officer were consistent with reasons other than being motivated by insider information.

Notwithstanding, the issue of "improper use" is fundamental to the operation of section 229 and while that matter remains in doubt, together with the judicial concern with the criminal nature of section 229, the effectiveness of that provision in the context of insider trading remains in doubt.

D. Securities Industry Code

1. Introduction

The most comprehensive provisions concerning regulation of insider trading are to be found in section 128 of the Securities Industry Code which "operates by casting the net over all dealings by those with insider knowledge or connections then, by permitted exemptions, allowing transactions of acceptable kinds to slip through."¹⁹ The section is complex and its operation can be understood only after careful consideration. In particular the section endeavours to provide for the following matters:

- the categories of persons who may contravene section 128;
- the nature of insider information;
- the dealings which are prohibited;
- allowable transactions and defences; and
- civil and criminal sanctions.

2. The insider defined

The following persons may be caught by the prohibitions within section 128:

- (i) A person who is or was within the preceding six months "connected with" (see below) the company and who is because of that connection in possession of inside information (section 128(1)).
- (ii) A person who has obtained inside information from a person whom he knows or ought to know is "connected with" the company. The recipient of such information is usually referred to as a "tippee" (section 128(3)).
- (iii) A body corporate in which a connected person or a tippee is an officer (section 128(6)).

Section 128(8) is significant because it defines who will be a "connected person" for the purposes of sub-section (1). It provides that a person is connected with a body corporate where:-

¹⁹ *Law of Companies in Australia*, CCH Australia Ltd., 1985 at p. 236.

- a. He is an officer (defined in section 128(11)) of that body or of a related body corporate (within the meaning of the Companies Code);
- b. He is a substantial shareholder (within the meaning of Companies Code) in that body corporate or in a related body corporate; or
- c. He occupies a position that may reasonably be expected to give him access to confidential, price-sensitive information by virtue of —
 - any professional or business relationship existing between himself (or his employer or body corporate of which he is an officer) and that body corporate or a related body corporate;
 - or
 - his being an officer of a substantial shareholder in that body corporate or a related body corporate.

The concept of a connected person is thus very widely drawn. It could cover for example the company's solicitor, merchant bankers, accountants, auditors, brokers, consultant geologists and the employees of such persons. Moreover, as Ford²⁰ suggests, the provision even covers as a result of a business relationship, persons in an arm's length relationship with the company, such as a person who has just negotiated a major contract which could materially benefit the company and its securities. And it should not be forgotten that an insider for the purposes of section 128 extends to the "tippees" of such connected persons thereby casting the net even wider.

One matter of concern is the fact that a "connected person" as defined will lose that status after becoming disassociated with the company for a period of at least six months. Clearly the definition of a connected person must, as indeed it does, extend to those who have no further association with the company otherwise the prohibition on insider trading could be avoided simply by a connected person resigning or formally terminating his relationship with the company, and then dealing in the company's securities while in possession of price-sensitive information. However, the time limit of six months being the period within which the connected person remains subject to the operation of section 128 appears to have been chosen arbitrarily and would seem to be a significant limitation on the operation of the section. One may envisage an office resigning from the company and the inside information which he possesses remaining confidential well outside the prescribed six months' period. At the expiration of that six months' period the former officer ceases to be a "connected person" and is able to trade with the advantage of inside information. It seems appropriate not to specify any time period and to provide that a connected person in possession of confidential price-sensitive information will remain so connected until such information becomes generally available.

It is apparent from the scheme of section 128 that sub-sections (1) and (2) are confined to insiders who are natural persons within the 'connected' person terms of section 128(8). Section 128(3) similarly only applies to a natural person who receives information from a person caught by section 128(1) and (2). From there however a company is precluded by section 128(6) from dealing in the securities when one of its officers is precluded by section 128(1), (2) or (3) from doing so. Although the word "person" is defined by section 9 of the Companies and Securities (Interpretation and Miscellaneous Provisions) Act 1980 as including — unless the contrary intention appears — "a body

²⁰ *Supra* N.5 at p. 717.

politic or corporate as well as a natural person", the scheme of section 128 as discussed above clearly evidences a "contrary intention" so as to negate the operation of this general definition.

Moreover other provisions support this approach to section 128. For instance section 130(1) which provides for compensation by a person acting in breach of section 128 imposes the obligation to compensate on:

- (a) a person who is in breach of sub-sections (1) (2) (3) or (4);
and
- (b) a person being a body corporate who deals in securities in contravention of section 128(6).

Section 130, therefore, makes it clear that a body corporate's liability under section 128 arises only under sub-section (6).

The practical consequence of this scheme is that a plaintiff will not be able to allege that a body corporate is an insider and in possession of inside information within the terms of section 128(1), (2) and (3). It will be necessary where a body corporate is alleged to have contravened section 128 to establish that an officer of that body corporate is an insider and as a result the body corporate is affected by the insider status of its officer.

3. *The prohibitions*

Having established the categories of persons who constitute insiders for the purpose of section 128, that provision then proceeds to state the prohibitions to which such insiders are subject. They are as follows:-

(a) *Section 128(1)*

Section 128(1) which we shall examine in depth prohibits a "connected person" from dealing in securities of his own company if by reason of his connection with that company he is in possession of information that is not generally available, but if it were, would be likely materially to affect the price of those securities. Contravention of such prohibition constitutes an offence (section 129) and may render the insider liable to compensate the other party to the transaction for any loss sustained and to account to the company for any profit accruing (section 130).

At the outset it is important to note that section 128(1) is contravened simply by dealing. The mere fact that the insider has the required information and trades is sufficient for liability, both criminal and civil. It is not necessary for instance to establish the insider's motive or purpose in dealing or that he has acted intentionally in relation to all the elements of the prohibition. Nor would it appear to be relevant that the insider may not be aware of the price-sensitive nature of the information in his possession. One commentator²¹ has described this situation in the following terms:

"The irrelevance of the insider's purpose and the irrelevance of his belief that the information was not material combine to make [section 128(1)] a powerful inhibition of any dealing by an insider. We are brought very near to law which would say that a person connected with a company should never deal in the company's securities."

²¹ "The Insider Trading Provisions of the Federal Corporations and Securities Industry Bill 1975", (1976) 12 W.A.L.R. 254 at 273.

This position may be compared with the Companies Act 1980 (UK), section 68(1) which provides that “an individual who is . . . knowingly connected with a company shall not deal . . . in securities of that company if he has information which . . . he knows is unpublished price sensitive information in relation to those securities”. The word “knows” in the UK provision imports a subjective state of mind and thus requires proof of intention and subjective appreciation of the relevant facts.

Although contravention of the prohibition under section 128(1) does not necessitate proof of the insider’s motive or intention, it is clear that any action against the insider must establish that the inside information involved is of the kind with which section 128(1) is concerned. In the first place that provision refers to the insider being in possession of “information” without that term being qualified by any narrowing word such as “special” or “specific”. This is likely to be intentional for the legislature has undoubtedly had cognisance of decisions which touched upon the meaning of terms such as “specific information” and sought to avoid the implications arising from such cases. For instance in *Green v. Charterhouse Group of Canada Ltd*²² the Court held that knowledge of negotiations concerning a possible take-over which in fact did subsequently proceed to completion was not “specific information” because the negotiations at the relevant time were “preliminary and uncertain”. Similarly in *Ryan v. Triguboff*²³ Lee J. stated “. . . the fundamental error in the prosecution case is the attempt to allege as “specific information” that which is not existing fact but generalised deduction”.

It is suggested that section 128(1) will extend to information which is veiled or tentative but which nonetheless has given rise to deduction or inference which would only be available to the insider to make and which have been the basis of his decision to trade. The present position is illustrated by dicta from *Waldron v. Green*²⁴. Here the insider contended that “information” meant “factual knowledge of a concrete kind, not rumour, possibility or speculative suggestion nor information of a kind that is preliminary or uncertain. The information must entail some degree of specificity”. In response to this contention McInerney J. has provided guidelines which may be used when considering the nature of information within the meaning of section 128(1). He stated: “Our section does not require that the information be ‘specific’. In many cases a hint may suggest information or may enable an inference to be drawn as to information. Information about impending stock movements or share movements may often be veiled. Discussion concerning such a movement may often take the form of ‘mooting’ but not deciding a matter”.

And so although the information which has motivated trading must be something more than a hunch or a shrewd or educated guess, any opinions, predictions, deductions, and suchlike perceptions capable of being made only by an insider will be sufficient information to satisfy the operation of section 128(1). It is regrettable that the opportunity was not taken by the legislature to provide a definition of “information” so as to place the matter beyond doubt. On this matter Anisman states in the NCSC Issues Paper (at p. 90) that it is “advisable to consider a definition of ‘information’ to ensure that it includes facts, intentions, opinions and other data that may give rise to an inference about future events or value”.

²² (1973) 35 DLR (3d) 161.

²³ [1976] 1 NSWLR 588.

²⁴ Supra note 15.

Section 128(l) further requires that such information is to be "not generally available" and "likely materially to affect the price of those securities". The requirement that the information "is not generally available", although a question of fact in each case is nonetheless a most vague concept. No guidelines at all are given as to what is sufficient dissemination of information. For instance, rumours are often prevalent around the stock market and most commonly form the basis of active trading. Accordingly one may ask whether a court — in the event that such rumours prove to be accurate — will recognize that information has been generally available to the investor public in such circumstances so as to prevent the operation of section 128(l).

A further problem concerning dissemination of information arises from the fact that no time period is prescribed for investigation or absorption of the facts by investors after general release. The insider, arguably, can trade as soon as the material, which may be very complex, is announced. He may thereby gain considerable advantage over investors. At the moment the only means of preventing this is an argument to the effect that, notwithstanding general release, information is not generally available until a reasonable period for its investigation and absorption has lapsed. In *SEC v. Texas Gulf Sulphur Co*²⁵ the problem was recognised by the Court which observed that "where the news is of a sort which is not readily translatable into investment action, insiders may not take advantage of their advance opportunity to evaluate the information by acting immediately upon dissemination" (p. 854). An insider may reasonably be expected to wait until he has no advantage over outside investors and accordingly a "waiting period" clause couched in terms similar to the above dicta may be appropriate. The alternative is to rely upon recognition by the courts that information in certain cases may not be generally available until a reasonable period for evaluation has been allowed. Insider trading within that period therefore remains subject to the statutory prohibition. In the NCSC Issues Paper Anisman has recognised the desirability of providing a period to permit information to be disseminated stating (at p. 98) "the statute should make clear that insiders cannot trade or tip until material information is disclosed in a manner that is likely to bring it to a reasonable investor's notice and sufficient time has passed for this process to have occurred".

In order to constitute inside information not only must it be established that the information was not generally available but further that the information which was not so available "would be likely materially to affect the price of those securities" (section 128(l)). Here an objective test has clearly been established with its emphasis on reasonable and objective contemplation of the possible effect of information on security prices. The provision has the consequence of not allowing an insider to escape liability on the basis of his own subjective belief as to the likely effect of information on the price of securities.

In our consideration of the prohibition contained in section 128(l) it has been observed that terms such as "information", "not generally available", "likely materially to affect the price of securities" have been adopted by the legislature. It is clear in view of the uncertainties and judicial discretion inherent in these terms and the criminal offence involved that the courts will be likely to make decisions on policy grounds based, hopefully, on an understanding of the type of matter which the prohibition is aimed at controlling. Predictably

²⁵ 401 F 2d 833, (1968).

the courts will be concerned to distinguish a genuine case of exploitation of outsiders from one in which an insider has his own specialised knowledge of the company's operation and a thorough understanding of its affairs generally. The line however will not always be easily drawn.

No such difficulty was experienced by the New South Wales Court of Appeal recently when it was required to consider whether it was appropriate to allow the prohibition to operate so as to prevent a person connected with a body corporate from dealing in securities of that corporation pursuant to an underwriting agreement. The case, *Hooker Investments Pty. Ltd. v. Baring Bros. Halkerston and Partners Securities Ltd.*²⁶ arose as follows.

Until the 21st February 1986 the defendant had been retained by Email Ltd to provide corporate and financial advice. On 21st February 1986 the directors of Email resolved to issue 16,185,000 shares at \$1.75 per share. At all times one Mark Burrows was an employee of the defendant. Burrows, it was alleged, "occupied a position that may reasonably be expected to have given him access to certain information by virtue of a professional or business relationship" with Email. In particular the information consisted of the estimates of profit of Email for the year ended 31st March 1986. This information, it was alleged, "was not generally available, but, if it were, would be likely materially to affect the price of ordinary shares (in Email)." On the 21st February 1986 Burrows' employer, the defendant, agreed with Email that it would underwrite the issue of the 16,185,000 shares at \$1.75 per share. The conduct of the defendant in entering into the underwriting agreement was alleged to constitute breaches of section 128.

Essentially Hooker Investment, the plaintiff, sought to restrain the allotment of shares in Email pursuant to the underwriting agreement because it believed that its own shares in Email would be diminished in value by the issue of a large number of other shares by the underwriter at a lower value.

Hooker Investment reasoned that Burrows, being a person connected with Email could not under the terms of section 128(l) deal in any securities of Email and accordingly, pursuant to section 128(6), the defendant, his employer, similarly could not deal in Email securities, given that Burrows was so precluded. Hooker Investment placed particular emphasis on the fact that under section 4 of the Securities Industries Code "dealing" in relation to securities is defined as (inter alia) "subscribing for or underwriting the securities" and "securities" means (inter alia) ". . . shares . . . issued or proposed to be issued by a body corporate."

Despite the apparent literal application of section 128(l) to Burrows, the Court was of the opinion that "the argument for Hooker is misconceived", holding that section 128 was concerned with transactions between insiders and outsiders trading in securities and not underwriting agreements in respect of shares proposed to be issued. Also the meaning of "dealing" and "securities" in section 128 was held to be narrower than the definition of those terms in section 4 given the intended operation of section 128. It was further recognised by the Court that "if section 128(l) applied to an underwriting agreement with a specified individual in respect of a proposed issue of shares, a body corporate would often have great difficulty in entering into an underwriting agreement. An officer of that corporation would very frequently be in possession of information that is not generally available but, if it were, would be likely

²⁶ Supra note 16.

materially to affect the price of the proposed issue. The effect of section 128(6) would be to preclude the body corporate from entering into the underwriting agreement . . .”

Clearly (and rightfully it is suggested) the Court recognized that section 128 was directed to parties trading in the market place where a price could be affected by unpublished inside information, resulting in one person, the insider, having an unfair advantage over another. The parties to an underwriting agreement do not come within this policy objective.

(b) *Section 128(2)*

The second prohibition is contained in section 128(2) and is primarily directed at persons connected with an offeror or offeree company in a takeover situation. Both the persons connected with the offeror company and with the target company will invariably have advance information not only relevant to the share prices of their own company but also relevant to the share prices of the other company involved.

And so section 128(2) prohibits a person who is “connected with” (see above) a company (Company A), from dealing in the securities of any other company (Company B):

- if by reason of his connection with Company A;
- he is in possession of information that is not generally available;
- but if it were generally available would be likely materially to affect the price of the securities of Company B; and
- the information relates to any transaction (actual or expected) involving both Company A and Company B or involving one of them and securities of the other.

It can be seen that while the connection is with one company the prohibition is in relation to dealing in the securities of another company. Dealing with the securities in one’s own company on the basis of such information would be caught by the prohibition contained in section 128(1). Also the prohibition contained in section 128(2), although of particular relevance to take-over situations, is not confined to such cases. As Baxt et al²⁷ suggest, the situation “may involve a contract between the two companies which will involve certain expertise being transferred from Company A to Company B in return for the issue of shares from B to A. A number of possibilities or permutations arise”.

(c) *Section 128(3)*

Section 128(3) contains the prohibition directed at tippees. It prohibits the dealing in securities by a person not connected with a particular company but who nevertheless is in possession of information which would be likely materially to affect the price of securities of that company, having obtained that information from a person who is himself precluded from dealing in those securities by virtue of section 128(1) or (2) as the case may be.

The prohibition only applies to a tippee who knew or ought reasonably to have been aware that the primary insider was precluded from dealing,

²⁷ *An Introduction to the Securities Industry Codes*, R. Baxt et al., Butterworths, 2nd Edition, 1982, 257.

and who is “associated with” the primary insider or had “with him an arrangement for the communication of information” of the relevant kind.

An “associated person” is defined in section 6 of the Securities Industry Code and covers inter alia partners, trustees, or a person or company which is accustomed to obeying the directions of the primary insider or is under some obligation to act in a certain way in relation to the securities. Significantly a spouse or other relative is not by that fact alone included in the term “associated person”. They will be tippees usually by virtue of an arrangement entered into with the primary insider for the communication of information.

The nature of such arrangements is understandably not specified. Any arrangement formal or informal which involves the passing of relevant information on to another person so that it might be used for the advantage of either or both of them will be the kind of arrangement envisaged by the provision. It can be seen that the curious cleaning lady looking through the primary insider’s waste paper basket would not be a “tippee” for the purposes of this provision but a financial printer, supplier, or trade union official might be. Note also that in the case of primary insider trading the prohibition applies to dealing while he is connected with the company or within the 6 months’ period following termination of this relationship. Here however it would appear not be matter when the tippee decides to exploit the information. Provided he has received the relevant information in the circumstances described above he is prohibited from dealing in the securities concerned while the information remains inside information.

(d) *Section 128(5)*

Section 128(5) is concerned to establish “tipper liability” by prohibiting a person who is precluded from dealing under section 128(1), (2) and (3) from communicating price sensitive information to any other person.

Tipper liability is, however, confined to cases where:

- the securities about which the information is given are listed on a stock exchange; and
- the tipper knows or ought reasonably to know that the other party will make use of that information.

(e) *Section 128(4)*

Section 128(4) prohibits a person who is precluded from dealing in securities by section 128(1), (2) or (3) from causing or procuring any other person to deal in those securities. The provision is clearly aimed at prohibiting the appointment of a nominee or agent by a person who has been prohibited from trading in securities by these various provisions.

(f) *Section 128(6)*

Section 128(6) prohibits a body corporate from dealing in any securities at a time when an officer of that body corporate is precluded from dealing in those securities by section 128(1), (2) or (3).

The provision covers the gap left in these various sub-sections where only natural persons are referred to. However the prohibition is subject to two major exemptions. First pursuant to section 128(7) a body corporate is not precluded from dealing by reason that one of its officers has inside information provided that such officer does not make the decision to enter the transaction

and the company has arrangements in operation to ensure that the inside information which its officer has acquired is not communicated to the person in the company responsible for the investment decision. In essence the legislature has recognised the separation of functions within a given company between those persons who are privy to inside information about other companies and those officers of the company who are concerned with investment decisions involving those other companies. The arrangements by which such separation is achieved is known as the "Chinese Wall".

The insulation approach and the allowed exemption is particularly relevant to institutional investors. One commentator writes²⁸:

"Particular concern has been voiced by life assurance officers and similar institutions which have large company shareholdings and who are in the habit of paying periodic visits to company managements to check on their investments. If following such a visit, an order to buy or sell shares in the company was placed on the basis of information obtained by the research staff of a large investor, there might well have been a contravention of the Act. The Australian Mutual Provident Society has sought to protect itself by writing to managements informing them of forthcoming company visits and explaining that the interviewing officer will be aiming to extend his general information of the company and its industry and will not be seeking any special inside information about the company".

Here the AMP has arguably been successful in ensuring that its employee will not be privy to special inside information so as to avoid the operation of section 128(6). In other cases, however, it is suggested that such arrangements will not be possible. For instance in a case where an AMP officer is a member of the board of management of a company in which the AMP has an interest. Here the AMP will be likely to contravene section 128(6) unless it can establish a "Chinese Wall" between its officer/board member and those other officers of the AMP who are concerned with investment decisions relating to that company's securities.

It is in response to such concern that the insulation concept was introduced by section 128(7). Although this would appear to be an important method of avoiding contravention of section 128(6) it is widely recognised that it is unlikely to work in practice. Any "Chinese Wall", no matter how comprehensive, is bound to be less than satisfactory and there must be a substantial risk of price-sensitive information being conveyed to the decision maker. For instance a company having a senior officer with general responsibilities over the whole of the undertaking of the company will be seen straddling the Chinese Wall in an uncomfortable position.

The second exemption to the prohibition in section 128(6) is that contained in section 128(7A). This section was introduced in 1983 and was designed to clarify the position of a company proposing to launch a takeover bid. Where an officer of a company possesses inside information of a target company, the intending bidder is not prohibited from dealing in the target's securities, provided, however, that the information must have been obtained by the officer of the intending offeror in the course of performing his duties and must relate to the proposed bid.

²⁸ S.R. Bailey, "Insiders, Inside Information and The Securities Industry Act 1975", [1977], A.B.L.R. 269, 270.

4. Allowable transactions

Holders of dealers' licences under the Securities Industry Code who would otherwise be insiders for the purposes of section 128 may deal in listed securities provided they comply with the requirements of section 128(9)(a) — (c) viz., the holder of the licence deals on specific instructions as agent for another person, who is not an associate of the dealer, and to whom the dealer has not given advice in relation to dealing in securities of the company.

In addition Regulation 46 of the Securities Industry Regulations exempts certain dealings from the prohibitions contained in section 128. For example, a dealing by a director to acquire a share qualification and the acquisition of securities of a corporation by a superannuation scheme or pension fund for the benefit of employees of the company concerned are two instances of exempted transactions where the party acquiring the securities are insiders and possibly in possession of inside information which would in other circumstances amount to dealings in contravention of section 128.

5. Statutory defence

Section 128(10) provides that it is a defence to a prosecution instituted against a person alleged to be in possession of information and to have entered into a transaction in contravention of section 128 where that person satisfies the court that the other party to the transaction knew or ought reasonably to have known of that information before entering into the transaction.

6. The sanction

Section 129 provides in the case of a natural person a criminal sanction of 5 years' imprisonment or \$2,000 or both and in the case of a body corporate a penalty of \$50,000.

7. Civil liability

Section 130(1)(c) provides that a connected person (within the meaning of section 128(1) or (2)) or a tippee (within the meaning of section 128(3)), who deals in securities or causes or procures another to do so (as envisaged by section 128(4)), and a body corporate who deals in securities in contravention of section 128(6), is liable to compensate any other party to the transaction for any loss sustained by that party.

The amount of loss is measured by the difference between the actual transacted price and the price that those same securities would "likely" have brought if the inside information had in fact been generally known. The "likely" price would be, in the case of a stock exchange transaction, the price at which the shares would probably be traded. For face-to-face transactions it would be the price the parties would have agreed to if the facts were known.

The only offence which does not expose an insider to a liability to compensate is that of communicating price sensitive information as prohibited by section 128(5).

Civil liability is also provided for in section 130(1)(d) which requires the insider to account to the company for any profit accruing to the insider from the transaction.

By section 130(6) the NCSC may, if it is in the public interest, bring an action on behalf of the company or person with whom the insider traded. One would think that if the action is clearly one relating to insider trading it would always be in the public interest to bring an action.

The civil right of action provided for in section 130 must be brought within 2 years from the date of completion of the transaction. Such limitation seems unsatisfactory for it means that the insider can avoid liability if he can suppress the fact of his trading for the limitation period. It is suggested that a more appropriate limitation period would be two years from the discovery by the innocent party of the facts constituting the cause of action.

III. FUTURE DIRECTIONS

A. Introduction

The NCSC in its 1983/83 Annual Report stated that it was undertaking a review of the law relating to insider trading "because of the importance of the statutory prohibition on insider trading in ensuring that the securities market operates freely and fairly and investor confidence is maintained. Although egregious conduct of this nature is reputedly not uncommon, the difficulties of detection and proof are such that successful prosecutions under section 128 of the Securities Industry Code and antecedent legislation, have been rare."²⁹

In November 1986 the review culminated in the publication of an Issues Paper on insider trading which had been prepared for an NCSC working party. The paper is the product of Philip Anisman who, at the time of his engagement, was a Professor of Law at Osgoode Law School, York University in Toronto, Canada.

Although it is not possible to offer a detailed discussion of the various proposals in the report (a task already undertaken by others³⁰) it is nonetheless desirable to summarise its content.

Essentially the report can be divided into three major parts. The first part (Chapters one to three) is concerned to provide an understanding of what amounts to insider trading by providing a clear definition of "insider", establishing the nature of "insider information" and describing the conduct ("the proscribed conduct") which is to be prohibited. All technical expressions such as "insiders", "deemed insiders", "material information", "confidential information" are carefully defined in the proposals as are the defences to the proscribed conduct. The second part of the report is concerned with sanctions and remedies both criminal and civil and will be the subject of further comment below. The third part of the report provides a model insider trading statute (drafted in the Australian style) incorporating the recommendations made throughout the report. The significant aspects of the proposed legislation may be summarised as follows:

- "Material information" is defined as information to which a reasonable person would attach importance under the circumstances in determining whether to buy or sell securities (paragraph 1(l)(f)).
- "Public information" is defined to specify a waiting period after material information is made public before insiders can trade (paragraph 1(l)(g)).
- Where a takeover bid is proposed, insiders of the intending bidder are also insiders of the proposed target (paragraph 1(3)).
- The insider of an intending material buyer or seller of securities is an insider of the issuer (paragraph 1(4)).

²⁹ NCSC 4th Annual Report, para 3.6.5, p. 40.

³⁰ "Securities Law Reform" Seminar Papers, BLEC Publications, February 1987.

- Intending publishers of client investment advice and insiders of such publishers are insiders of the issuers of securities which are the subject of the advice (paragraphs 1(5), (6)).
- Government officials are insiders of companies concerning which they have information (paragraph 1(7)).
- "Tippees" and "subtippees" of the insiders are also insiders (paragraph 1(l)(e)(vii)).
- It is an offence for an insider who knows material confidential information to buy or sell securities (paragraph 3(l)).
- It is an offence for an insider who knows material confidential information to cause another person to buy or sell securities, or to inform another person who may trade in the securities (paragraphs 4(l), (2), (3)).
- It is a defence to establish a Chinese Wall (paragraphs 3(3), 4(6)).
- The penalty for trading directly and causing trading is a mandatory fine equal to any profit made, with a further power in the Court to levy an additional fine up to twice the profit and imprisonment (paragraphs 5(l), (2)).
- The penalty for advising trading is a mandatory fine of the greater of \$20,000 or the amount of a resulting profit made, with liability for an additional fine of up to twice the profit and imprisonment (paragraph 4(3)).
- The penalty for communicating (tipping) is a mandatory fine of the greater of \$30,000 or the amount of a resulting profit with liability to a further fine of twice the amount of the profit and imprisonment (paragraph 5(4)).
- Criminal fines and civil liability provide an integrated fund to be used to compensate investors who suffer harm from an insider's trading. Any fine imposed is to be paid into a statutory general fund (paragraphs 9(7), 10(6), 13(l)).
- An insider in a direct transaction contravening the law may be required either to rescind or account for the profit (paragraph 9(l)).
- An insider who causes a direct transaction contravening the law may be required either to rescind or account for the profit (paragraph 9(l)).
- An insider who causes a direct transaction contravening the law is liable to the other party for the amount of profit (paragraphs 9(2), (3), (4)).
- An insider to a direct transaction is also liable to contribute to the statutory general fund (paragraph 9(5)).
- An insider in an impersonal (eg market) transaction contravening the law is liable to pay three times the amount of profit into the statutory general fund (paragraphs 10(l), (2), (3), (4)).
- An action may be brought in relation to an impersonal transaction by the issuer, the Commission or by any person who dealt on the day, or any day thereafter until the information became public. The proceeds are paid to the statutory general fund (paragraphs 11(2), 13(2)).
- The amount in the statutory general fund is pro-rated among the persons who apply to be awarded compensation as persons to whom the insider is liable (paragraph 13(3)).
- Actions must be commenced within two years of the plaintiff becoming aware of the facts, but no later than six years after the purchase or sale (paragraph 14).

In the public debate following the release of the Issues Paper the point has been consistently made that the present insider trading provisions are

largely untried. Certainly the provisions can be improved but is the failure to secure a successful prosecution under existing provisions due to their inadequacy? Arguably it has been the effect of inadequate resources within the NCSC, in terms of manpower, expertise and funds, which has prevented the NCSC from dealing in any creative manner with alleged breaches of insider trading laws. It seems highly unlikely, therefore, that the practice of insider trading in this country will be contained by merely tightening up the Act and imposing more realistic penalties. Effective control needs an effective insider policy and strategy which will ensure that the NCSC can adequately investigate and enforce the prohibitions under the Code.

One assumes that it is for reasons of this kind that the NCSC has throughout 1987 made it known that it has decided to defer large-scale reform of the law on insider trading until it has upgraded its detection and enforcement strategies and tested the present law.

To this end the NCSC has made it known through press releases that it is investigating three unrelated major cases of insider trading and that prosecutions in due course are to be brought in NSW, Victoria and Western Australia. The Commission has made it clear that the cases are designed to test the interpretation of the current law in the States involved and have not been instituted with a view to unearthing profits on the scale of recent overseas cases.

From the foregoing it can be seen that notwithstanding comprehensive provisions under which the insider is defined and proscribed conduct determined it is essential to provide an effective means for the detection and investigation of insider trading together with adequate criminal sanctions and civil remedies. Accordingly any review of future directions warrants particular consideration of these aspects.

B. Disclosure and Investigation of Insider Trading

Regulation of insider trading will only be effective when insiders sense with a reasonable degree of certainty that there will be a reasonable chance of detection of any violation of the proscribed prohibition and that the detection of such violation will be followed by a thorough investigation. Rider and Ffrench³¹ state:

“. . . in practical terms the effect of the deterrent must depend upon the predictability of application and the personal unpleasantness of the consequence. Where there is a high probability of application and the consequence of such is sufficiently unattractive then the deterrent aspect is a very important consideration in the regulation of insider trading.”

The likelihood of detection of insider trading depends greatly on the circumstances in which the trading took place. For instance where a transaction involves unquoted securities and is executed on a “face-to-face” basis the party dealing with the insider, on discovering the circumstances which motivated the insider to deal, may, if the sums involved are large enough, seek to pursue his remedies under section 130. In such cases the existing regulatory framework is adequate for the likelihood of detection is high and the action for damages

³¹ B.A.K. Rider and H.L. Ffrench, *The Regulation of Insider Trading*, Oceana Publications Inc., N.Y., 1979, at p. 418.

is of practical significance. Moreover the position of the aggrieved party will undoubtedly be brought to the attention of the NCSC who will then be in a position to institute proceedings both by way of prosecution and for recovery of damages on behalf of the aggrieved person (provided of course that the NCSC has the resources to do so and the resolve to act in such cases).

However, the problem of detection and hence deterrence arises mainly with trading on a stock exchange for in such cases the anonymity of the system effectively enables the insider to avoid detection. Existing stock exchange and broking procedures do not usually admit of identifying the parties to a particular transaction. As one commentator³² states:

“Where the selling broker and buying broker are each acting for particular clients, it may be possible for an aggrieved person to establish the identity of the other contracting party. However, where the selling broker is acting for a group of unascertained sellers and the buying broker for a group of unascertained buyers . . . it was difficult to see how there could be privity of contract between buyer and seller.”

Accordingly where a person considers that he has been duped by an insider or tippee in a market transaction (for example after reading a press release or learning of a take-over affecting his previously held securities) he will be in the unenviable position of having to show that he actually dealt with an insider or tippee. Furthermore as Rider and French³³ suggest:

“without something more than a sense of indignation the official agencies are unlikely to instigate an investigation on an individual investor’s behalf and without some kind of evidence of privity the judicial authorities would be equally reluctant to interfere. There is no obvious reason or public interest in the official authorities going to the possibly much greater trouble and expense of attempting a full tracing of the suspicious transactions.”

Although not solving this problem one step towards stopping insider trading in the market place is to place an obligation upon defined insiders to report their transactions in the securities of their own companies. To some extent such disclosure already exists under the Companies Code. Section 231 for example provides that a company shall keep a public register showing with respect to each *director* particulars of his securities in the company or a related company. The particulars to be shown in the register are to include the number and description of securities and in respect of transactions entered into after he became a director, the price or other consideration involved and the date of the transaction. In this manner movement of directors’ securities will be recorded. In addition section 232 provides that every director is under a duty to give notice in writing of particulars relating to dealings in the company’s securities so as to enable the company to keep the register as required under section 231. Such notice must be given within 14 days of the transaction and any default by the officer concerned in complying with these requirements constitutes an offence under the Code with a penalty of \$1,000 or imprisonment for 3 months or both (section 232 (6)).

³² P. Meyer, “Fraud and Manipulation in Securities Markets”, (1986), 4 C & S.L.J. 92, 102.

³³ Supra note 30 at p. 419.

In a similar manner the Companies Code requires the disclosure of substantial shareholdings (being 10% or more of a company's voting shares. Such shareholders are to give notification of their holdings to the company and any changes thereto (sections 137, 138) and the company is required to keep a public register of substantial shareholders (section 143).

These provisions are aimed at ensuring publicity through disclosure of dealings by an officer or substantial shareholder in securities of his own company. It is suggested, however, that the public register device is of limited use in achieving full disclosure of insider trading. For instance the disclosure provisions under the Code are confined to directors and substantial shareholders. Any endeavour to bring insider trading into the open must surely extend to officers of the company other than directors (for example employees) and possibly to the spouses and children of such directors and other company officers. In addition disclosure by means of the company's registers is particularly low-profile.

In considering a policy of deterrence through full disclosure it is appropriate to consider the U.S. experience. Section 16(a) of the Securities Exchange Act 1934 requires that "every person who is directly or indirectly the beneficial owner of more than 10% of any class of any equity security . . . or who is a director or an officer of the issuer of such security shall file . . . within 10 days after he becomes such beneficial owner, director, or officer, a statement with the Commission (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes in his ownership as have occurred during such calendar month."

Not only is the insider obliged to file a statement with the SEC indicating changes to his ownership within any given month, the Government Printing Office also publishes monthly reports detailing such changes in insider holdings and "an active financial press follows and publishes extracts from the statements filed".³⁴ In this manner details of insider trading are given a wide circulation. The U.S. policy is clear and reputedly effective recognising as it does that a primary insider who knows that his trading will become public knowledge will be less likely to engage in insider trading. It is surprising, however, that the changes in insider holdings need not be reported until 10 days after the end of the month in which the changes took place and that the reporting requirements do not extend to near relatives of major shareholders, directors and other officers of the company.

Of course crucial to deterrence through publicity is a strong enforcement of the reporting requirements. Where a person knows that discovery of his dealings if not reported by him would be unlikely there is a great incentive for him not to disclose. Moreover a failure to report a transaction may tend to be passed off as a simple administrative error or oversight and not a serious or improper act. If this attitude is allowed to arise then a system of deterrence through disclosure will fail. The consequences of an enforcement agency

³⁴ Supra note 27 at p. 245

demonstrating a forceful attitude is referred to by one Canadian commentator³⁵ when he states:

“A direction was issued to the effect that from this point onwards, those persons who failed to report would be subject to the full rigours of the law: namely, prosecution, application to the courts for a compliance order, or proceedings that would deny the insider the right to trade in securities in Ontario. The effect of the directive proved dramatic. The number of insider trading reports filed with the OSC during that year rose to 19,824 from 14,719 a year earlier.”

Baxt et al³⁶ observe that the U.S. legislation has been successful and that the courts have been vigorous in applying the statute. Clearly then there are lessons to be learned from the U.S. experience both in the nature of disclosure provisions and enforcement attitudes towards them. It is surprising that the NCSC Issues Paper has not addressed this question of disclosure of dealings by an insider.

But the U.S. initiative in this area does not stop with disclosure. In particular section 16(b) of the Securities Exchange Act provides that a company can claim any profit realized by an insider within the meaning of section 16(a) arising from a purchase and sale (or sale and purchase) of any security of his company effected within a period of less than 6 months, and that should the company not sue for the profit any shareholder may do so in the name of the company. In effect this is a liability which arises irrespective of whether the insider traded on the basis of inside information or not. All that need be established is a purchase and sale or a sale and purchase by the insider within the six months period. Thus section 16(b) penalizes insiders simply for trading in their company's securities and not for the reason that they did so on inside information to the disadvantage of those with whom they traded. For this reason it is suggested that such a provision is in substance a provision which prohibits “short-swing profit” transactions rather than insider trading. Accordingly, notwithstanding the merit of greater detection and compensation, the insider's civil liability founded on the elements of insider trading and strict liability of the kind contained in section 16(b) should be avoided.

Finally and consistent with the idea that prevention is better than prosecution and punishment after the event Hockley³⁷ observes:

“One of the most effective measures which has been proposed . . . is that stock should automatically be suspended if the increase in turnover or price should go beyond certain defined limits. In this regard the powers of the NCSC under section 40 of the Code could be expanded. With a suitable market surveillance system an automatic triggering mechanism would allow time for regulatory authorities to ascertain the reasons for dramatic changes in price or turnover of securities . . . such measures would provide an effective means of limiting the effect of manipulative practices . . . thereby aiding the objectives of market efficiency and investor protection.”

³⁵ *Canadian and American Attitudes on Insider Trading*, B.A.K. Rider and H.L. French, Oceana Publications Inc., N.Y., 1979, p. 223.

³⁶ *Supra* note 27.

³⁷ *Supra* note 30 at p. 104

Although these comments are directed towards market manipulative practices the concept of an automatic triggering device has equal validity for insider trading particularly in cases of large scale turnover by insiders.

C. Sanctions and Civil Liability

Not only do the insider trading provisions fail to establish a satisfactory means of detection of such conduct, but further, the existing provisions concerning sanctions and civil remedies are particularly unsatisfactory. Any legislation on insider trading must provide penalties, both criminal and civil, which offer a sufficient deterrent. The current criminal sanctions (a fixed maximum of \$50,000, 5 years imprisonment or both) are clearly not adequate particularly in view of the vast potential for profits which insider trading offers. The NCSC Issues Paper proposes that the criminal sanctions be increased to a mandatory penalty of at least the profit from the transaction, 10 years imprisonment, or both. This is an effective sanction particularly as it is also proposed that a court should be given the power to order the insider to pay a further fine of up to twice the profit made from a transaction and that the fines be paid into a statutory compensation fund.

In respect of civil remedies it is imperative to have redress which is well defined and readily implemented. The basic motive for insider trading is the profit motive and if that can be removed the practice should decrease.

It will be recalled that section 130 of the Securities Industry Code presently provides for a civil remedy to the other party to the transaction for a loss sustained by that party. In addition a civil remedy is granted to the company for any profit made by the insider. The loss which the other party may claim is deemed to be the difference between the price at which the securities were dealt and the price at which they would have been likely to have been dealt if the information had been available. Such loss involves an evaluation of the probable market value if the facts were known. The company's claim on the other hand is stated to be based upon the actual profit realised by the insider. Also and most significantly the NCSC can, if it is in the public interest, bring an action on behalf of the company or person concerned to recover the loss or profit so allowed (section 130(6)).

A perceptive description of the operation of these civil liability provisions has been offered by Professor Parsons³⁸ in the following terms:

“Without [recovery by the Commission] neither the action to recover a loss nor the action to recover a profit would be of much significance. A person who has suffered a loss by having dealt with another may be deterred by the risk of defeat even though he will recover for his own benefit. The company is unlikely to bring an action against one of its senior officers, and it is a senior officer who is most likely to have made a profit from insider trading. It is true that an individual shareholder can assert the company's right of action in a derivative suit. But he is unlikely to do so when he runs the risk of defeat and the payment of costs, and when moreover if he succeeds, he recovers not for himself but for the company. How much significance the actions available to the person who has suffered loss and to the company to recover a profit, rather depends on how ready the Commission may be to take proceedings.”

³⁸ Supra note 21 at p. 260.

The ability of the commission to institute proceedings on its own initiative is essential but it is regrettable that the effectiveness of civil remedies are, as Parsons suggests, almost entirely dependent upon such ability and willingness of the Commission to act. Alternatives are possible; for instance, to provide radical new provisions which will, say, compel the company to recover all profits derived by the insider (where the elements of unlawful insider trading exist) and from the amount so recovered compensate those who have dealt with the insider and suffered loss.

Also significant problems exist should the Commission in fact decide to institute civil recovery under present provisions. In the first place there is difficulty co-ordinating the action available to the party dealing with the insider and the action available to the company to recover any profit made by the insider who gained the advantage. The relevant provision (section 130(3)) gives no guidance as to any priority between the two actions, only ensuring that any amount payable to one party will be allowed for in determining the amount payable to the other party so as to avoid double liability being imposed on the insider. Assuming, therefore, that the Commission has decided to act it will be faced with choosing between proceedings on behalf of the person who suffered the loss and proceedings on behalf of the company. This situation is obviously untenable. On the other hand in the unlikely event that the person trading with the insider and the company decided to pursue their respective civil remedies against the insider then whoever obtains judgment first will "win the jackpot, with nothing left over for the runner-up."³⁹

Legislative guidelines are essential to avoid these conflicts even if merely to provide, for example, that the destination of the proceeds recovered from the insider should be left for the court to decide in the circumstance of each case. Alternatively the legislature may be persuaded to provide that, as between the company and the party dealing with the insider the latter should be given a priority in the collection of any loss occasioned by the dealing. Finally another possibility would be to allow double recovery.

One further difficulty arises in respect of civil liability where the transaction relates to insider dealings on a stock exchange. In such dealings the matching of vendor and purchaser is entirely random and fortuitous and so there is some doubt as to the merit of that party acquiring a right of action against the insider, being in essence a windfall (assuming of course that it is even possible for that party to overcome the anonymity of market transactions and discover that he dealt with an insider).

Because of the anonymity of the market system, and the fact that in any event the party dealing with the insider arguably ought not to have the fortuitous advantage of recovery, the civil remedy provision should be amended to reflect the reality of such "faceless" market transactions. Parsons⁴⁰ in such circumstances refers to the prospect of making the insider liable to all persons who deal in the company's securities between the day when the insider first unlawfully traded and the day when the price sensitive information became generally available. Such liability, however, will be limited to the amount of profit derived by the insider throughout this period. Such profit will then be disgorged to all the outsiders dealing in this period on a pro rata basis depending on the amount of loss suffered by each. Although this would mean

³⁹ Australian Securities Law Reporter, CCH Australia Ltd., p. 16,004, para. 10-150.

⁴⁰ *Supra* note 21 at pp. 291-2.

less for the actual party or parties who dealt with the insider it can be justified on the basis that non-disclosure in a market transaction is effectively non-disclosure to all investors and not merely to the immediate party chosen at random to deal with the insider.

Such a scheme might be implemented by the insider accounting to the company for the whole of the profit gained from insider trading and the Commission inviting claims from all those who dealt on the market during the relevant period of insider trading. The NCSC Issues Paper has recognized this "faceless" aspect of a market transaction proposing that an insider contravening the law in such circumstances is liable to pay compensation into a statutory general fund which shall be prorated among the persons who apply to be awarded compensation as persons to whom the insider is liable (paragraph 13(3) refers).

A further desirable feature of the Anisman proposals is the integration of the criminal and civil liabilities so that the criminal fine might be retained for a specified period as a fund available to compensate investors who succeed in a subsequent civil action. Essentially the proposal establishes a maximum penalty of three times the profit no matter how the actions are initiated. Moreover, the burden of proof is also rationalised so that a conviction will be treated as conclusive evidence of liability in a subsequent civil proceeding, subject to an insider's opportunity to present a defence peculiar to civil liability.

D. Summary

In considering future directions for insider trading legislation in Australia it has been suggested that attention be given in the first instance to the establishment of a more effective means of detection and investigation of insider trading. To this end disclosure of security dealings by insiders should be made to the company and the Commission with further publicity being provided by way of a regular Commission report and financial press releases. In this manner detection of insider trading is more likely to occur than is presently the case. Such disclosure and publicity will not only provide the Commission with a basis for investigations (thereby avoiding an unsubstantiated, broad brush approach) but will in itself operate as a deterrent to the practice of insider trading. It will also help to overcome the criticism often levelled at the NCSC that we do not have any information of the existence of insider trading other than that which is essentially anecdotal.

Finally in the context of detection and investigation it is particularly significant that in recent times the NCSC has made it widely known that the co-operation of the Australian Merchant Bankers' Association and the Australian Stock Exchanges has been secured in the clamp down on insider trading. The vital role of such organisations has been described by the Honourable Jim Kennan MLC, the Victorian Attorney-General, in the following terms⁴¹:

"Detection of insider trading will always remain a problem, however great the powers of investigation and the penalties for infringement are. All the goodwill and all the legislative and administrative powers in the world will not work unless we can develop mechanisms which detect and report insider trading.

⁴¹ Hon. J. Kennan MLC., "Insider Trading", March 1987, Companies and Securities Bulletin, No. 47, at p.4.

These mechanisms will only develop if the NCSC has the cooperation and active assistance of the Stock Exchanges and the various clearing houses responsible for other financial markets such as the futures markets. It is the Stock Exchanges and the various clearing houses which have access to and control of the very market in which much of the activity resulting from the use of insider information takes place. It is their vigilance and their sense of the market which would be the first indicator that something is amiss. It is their records which could provide the most accurate and most striking evidence of market transactions. It is the information that they provide that is needed if investigations are to start. It is their cooperation which is essential to the effective operation of insider trading laws and the change in market philosophy about the legitimate use of insider information which is needed for insider trading activity to be brought under control."

In addition to more effective disclosure provisions it is also essential to strengthen the existing provisions relating to criminal sanctions and civil liability and the NCSC Issues Paper provides a particularly sound and feasible approach to this area.

IV. CONCLUSION

In attempting to make any assessment of insider trading laws (including the proposals contained in the NCSC Issues Paper) the purpose and strategy of the legislation needs to be carefully examined. If future strategy is directed at detection then little will be achieved with the low-level of resources currently provided to the Commission. Better detection and enforcement will not flow from re-defining "insider trading" and "insiders". In fact there exists a responsible school of thought which believes that legislative enactment in this area will be more effective (given a sound enforcement strategy) where the law is a little vague around the edges.

If the future strategy behind insider trading laws is to provide a deterrent against insider trading then it is imperative to introduce penalties, both criminal and civil, which are realistic. Even more important, however, is the need to develop the active co-operation and assistance of the stock-exchange authorities and the securities industry generally.

For the first time in the history of Australian insider trading we are poised to implement meaningful detection and deterrent strategies. The Anisman issues paper has largely been responsible for generating a re-consideration of the way in which we need to effectively control insider trading and at the very least has provided the impetus behind the NCSC test cases which are going to really set the cat among the pigeons.