LAW COUNCIL OF AUSTRALIA

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Submission prepared by
Corporations Committee
Business Law Section

Insider Trading Proposals Paper

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Insider Trading Proposals Paper

1. Introduction

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

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

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

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

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

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

2. Markets and Products

(a) Introduction

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

(b) Nature of the product

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

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

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

(c) Nature of the market

The Committee also believes that nature of most markets for commodity derivatives militates against the application of insider trading laws. The Committee believes that the fairness and efficiency considerations underpinning insider trading laws only justify the application of those laws to anonymous markets whose operations depends upon information being disclosed to market participants on an equal basis. In the context of commodity derivatives, the Committee does not believe that insider trading laws should apply to private transactions or to transactions in over the counter

markets where the market participants are typically professional investors who do not expect all market participants to have equal access to information and who are able to regulate their transactions by privately negotiated contracts.

(d) Recommendations

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

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

In these circumstances, the Committee recommends that:

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

3. Disclosable Information Element

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

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

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

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

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

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

The Committee therefore recommends that:

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

4. Carve outs

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

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

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

5. Other Issues

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

- The Committee opposes the proposal to introduce rebuttable presumptions that senior corporate officers are aware of inside information originating within, or known to, their company. As a matter of principle, the Committee opposes the introduction of rebuttable presumptions into legislation that carries serious criminal penalties. The Committee is not aware of there being evidence which demonstrates that practical problems of proof have been experienced to such an extent that any reversal of the burden of proof is warranted. We do not believe that such a significant step should be taken on the basis of anecdotal evidence or

assumptions. The Committee's concerns are also influenced by the fact that legislative definitions of "senior company officers" are usually very broad and often apply to a wide range of people who would not typically have access to price sensitive information known to their company.

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

- The Committee does not support the extension of compensation claimants beyond the insider's counterparty. We believe this would be punitive, not remedial. In our view, the claims of "contemporaneous traders" could not properly be regarded as claims for "compensation". In our submission, civil remedies for insider trading are more properly viewed as being in the nature of an "account" than "damages" and should be limited accordingly.
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- The Committee believes that insider trading laws should allow directors of takeover target companies to communicate information to a potential white knight if that is done on a basis which precludes the white knight from buying shares before the information becomes generally available. The rationale stated in paragraph 4.52 of the Proposal Paper for the contrary view is that a white knight "buying from an uninformed vendor" has an adverse affect on market fairness, efficiency, integrity and confidence. However, if the defence only permits the **communication** of information when the market is uninformed and does **not permit buying** activity until the information has become generally available, the white knight would not be involved in "buying from an uninformed vendor".

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

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

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

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

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