Insider Trading in Australia and New Zealand

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Australian Insider Trading Regime

- Australian regime widest in world - catches any person in possession of inside information (no connection to company required).
- Followed by Singapore, Malaysia and New Zealand. Why?
- Regime is aggressively enforced in Australia but not elsewhere.
- Focus in this presentation is on Australia as the most evolved of the “any person” regimes.
Australia

> Former British colony. Common law country with federal system. Legislative competency is split between two levels of government and this has shaped the form and history of securities regulation (as a subset of corporate law) in Australia.

> In 2012, a medium-sized economy with GDP of USD 1.5 trillion and a population base of approximately 22 million.

> The ASX, formerly the Australian Securities Exchange, is the main securities market.

> In March 2012, there were 2,223 companies listed the ASX and market capitalisation was AUD 1.3 trillion (8th largest in the world and 2nd largest in Asia-Pacific).
Background

> Insider trading not recognized as a problem until the 1970s with the release of the Rae Report (investigated securities activity in the Australian market during the mining boom of the 1960s and early 1970s and found instances of extensive insider trading activity had taken place during this period).

> State legislation was progressively introduced to regulate insider trading in the wake of the Rae Report’s findings.

> In 1980, the Commonwealth Government introduced the Securities Industry Act 1980 (Cth), which was designed to serve as a model for uniform State-based legislation. At this time, the first national corporate regulator, the National Companies and Securities Commission (NCSC) was established.
Background

> NCSC was replaced by subsequent authorities, the current regulator being the Australian Securities and Investments Commission (ASIC), which draws its regulatory authority from the *Australian Securities and Investments Commission Act 2001* (Cth).

> ASIC registers companies, investigates breaches of the law and enforces the law. ASIC enforces the law by bringing civil proceedings or by referring suspected criminal conduct to the Commonwealth Director of Public Prosecutions (the Commonwealth DPP).

> In 2010, ASIC’s functions were expanded to include the supervision of trading on Australia’s licensed equity, derivative and futures markets.
Policy

- NCSC commissioned the Anisman Report to investigate options for further reform.
- Commonwealth Government commissioned a further inquiry into reforming the insider trading provisions in 1989, headed by Alan Griffiths.
- The Griffiths Report made a total of 21 recommendations, including the removal of any requirement for a connection with the issuing company, clarification of the definition of “inside information” and a substantial increase in maximum penalties.
Policy (cont)

> Insider trading prohibition in Australia was broadened significantly, particularly in regard to the definition of “insider”.

> Reforms (implemented in 1991) removed any requirement that an insider have a connection with the issuing company, setting the relevant benchmark as mere possession of inside information.

> This standard has been maintained through to the present day and has served as a model for other jurisdictions (S/pore; M’sia and NZ).

> In 2001, Corporations Act 2001 (Cth) passed but the insider trading provisions have remained the same in most material respects since the 1991 reforms.
Policy Basis

- The policy bases on which the insider trading prohibition may be justified:
  - Fiduciary duty
  - Misappropriation
  - Market fairness
  - Market efficiency

Market Fairness Theory

Market fairness theory (sometimes referred to as the equal access theory or access to information theory) underpins the shape of the Australian provisions most strongly.

Equal access to information was put forward in the Anisman Report and the Griffiths Report picked up on this policy basis as being the most consistent with promoting investor confidence.

In essence, the market fairness theory maintains “that each and every participant in the securities market should be afforded equal access to inside information”.

Equality of access and the concomitant requirement for market fairness were particularly influential in *Firns* decision. (*R v Firns* (2001) 51 NSWLR 548).
Present Legislation

> The operative provision is s 1043A(1) which states:

  - Subject to this Subdivision, if:-
    - A person (the **insider**) possesses inside information; and
    - The insider knows, or ought reasonably to know, that the matters specified in paragraphs (a) and (b) of the definition of inside information in section 1042A are satisfied in relation to the information;

> the insider must not (whether as principal or agent):-

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

  - procure another person to apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.
Elements of Insider Trading

The elements of the offense of insider trading appear on the face of the legislation.

- The physical element is the possession of inside information.
- The requisite mental state is knowledge or constructive knowledge that the information is inside information.
- When prosecuted as a criminal offense, these elements must be proved by the prosecution beyond reasonable doubt: see Gregory Lyon and Jean du Plessis, *The Law of Insider Trading in Australia* (The Federation Press, 2005), 58.
Definition of Insider

> Only definition contained within s 1043A(1) itself is that of “insider”.

> Australia’s prohibition is one of the widest in the world. Unlike other comparable jurisdictions, such as the United States, which require some sort of connection between the party and the company whose securities are being traded, s 1043A(1) identifies an insider merely as someone in possession of inside information.

> This possession standard means that any party, regardless of relationship or position in respect of the relevant company, may come within the prohibition. This was a deliberate design intent behind s 1043A’s predecessor, s 1002G of the Corporations Law.
Definition of Information

> Inside information is a subset of the broader concept of “information”, requiring this latter notion to be defined before the prohibition has any content.

> Information is defined in s 1042A as including suppositions and other matters that are insufficiently definite to merit disclosure to the general public and matters relating to a person’s intentions.

> This inclusive definition goes no further than making explicit that these aspects are covered. In the result, an examination of judicial consideration of the term is required to identify its parameters.
Definition of Information (cont)

> An early prohibition on insider trading in Australia required that information be “specific”, leading the Supreme Court of New South Wales to hold that information, to be relevant to the prohibition, needed to be of a concrete kind.

> The legislative requirement that information be specific was removed from the subsequent New South Wales legislation.

> Young J in *Hooker Investments v Baring Bros* expanded upon the *Ryan v Triguboff* approach, holding that information as used in the legislation includes “factual knowledge of a concrete kind or that obtained by means of a hint or veiled suggestion from which one can impute knowledge”.
Definition of Information (cont)

> In interpreting the Victorian legislation McInerney J in *Commissioner for Corporate Affairs v Green* rejected a submission that information could not include “rumour, possibility or speculative suggestion nor information of a kind that is preliminary or uncertain”.

> In referring favourably to McInerney J’s approach in *Green*, Young J in *Hooker Investments* drew a distinction between information and knowledge.

> “I wonder … whether it is safe to equate information and knowledge. Information is often defined as knowledge acquired, derived or inculcated by observation, reading or study or by what one is told; but in some cases information implies lack of knowledge such as, for instance, where one says he is informed of a thing but he does not know whether or not his information is true.”
Definition of Inside Information (cont)

> “Inside information”, however, is the sole criterion by which a person is identified as being prohibited from trading in particular securities under s 1043A. Consequently, identifying information that falls into this category takes on a singular importance. Section 1042A defines inside information as information that is:

- not generally available;
- if it was generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products.

> This definition introduces two new concepts into the matrix - general availability and material effect.
Information that is not generally available

Section 1042C states:

For the purposes of this Division, information is generally available if:

- it consists of readily observable matter;
- both of the following subparagraphs apply:
  - it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information; and
  - since it was made known, a reasonable period for it to be disseminated among such persons has elapsed; or
- it consists of deductions, conclusions or inferences made or drawn from either or both of the following:
  - information referred to in paragraph (a);
  - information made known as mentioned in subparagraph (b)(i).
There are two basic pathways by which information can qualify as generally available under s 1042C (noting that the third listed is a derivation from the first two). These are the readily observable and publishable information tests.
Readily Observable Test

> The readily observable test contained in s 1042C(1)(a) raises a number of questions that have not been entirely resolved.

> An example is provided of a confidential company memorandum found lying in the street; it is certainly readily observable to the party who picked it up, but it seems at odds with the general notion of what constitutes generally available information.

> Lyon and du Plessis ask three open questions:-
   - By what means must the information be readily observable?
   - Readily observable to whom?
   - Observable where?
To be readily observable, it is enough that the information *may* be observed; there is no requirement that it actually *be* observed.

The test as to whether information is readily observable is objective and hypothetical.

In an increasingly internationalised and integrated securities market, the question of where the information needs to be readily observable also raises concerns about the intended scope and purpose of the prohibition, as demonstrated by the following cases.

The decisions in *R v Firns* and *R v Kruse* provide an excellent illustration of the problems that may arise under s 1042C as it currently stands. Both decisions emanate from the same fundamental facts.
Readily Observable Test: *R v Firns* and *R v Kruse*

> A mining company (Carpenter), which was listed on the Australian Stock Exchange (ASX), received a favourable court ruling in the Supreme Court of Papua New Guinea regarding a mining licence in July 1995.

> Kruse, an officer of Carpenter, was present in the Court at the time judgment was handed down. Very soon after the judgment, Kruse purchased shares in Carpenter through a broker in Australia, which were sold four days later for a profit of AUD 50,000.

> Firns was the son of another director in Carpenter, the latter also being present in the Court at the time the judgment was handed down. Soon after the judgment, the director phoned Firns (who was in Australia) and instructed him to purchase shares in Carpenter. Some 400,000 shares were purchased (in Firns’ wife’s maiden name), which were subsequently sold for a profit.
Readily Observable Test: *R v Firns* and *R v Kruse*

- The central issue in both cases was whether the relevant information (the court judgment) was readily observable as required under s 1002B of the *Corporations Law* (the forerunner to s 1042C).
- In both cases, the central issue came down to whether the information had to be readily observable in Australia.
- The only material difference in the facts between *Kruse* and *Firns* was the location of the defendant at the relevant time; that is, Kruse was in Papua New Guinea and observed the information first-hand, whereas Firns was in Australia and received the information via a telephone call.
Publishable Information Test

> Section 1042C(1)(b) - an alternative means by which information may qualify as generally available.

> There are two components to this test: the information has been made known in a manner at least likely to come to the attention of regular investors and a reasonable period of time for dissemination has elapsed.

> The first requirement consists of two aspects, namely the manner of publication and the class of person likely to invest in relevant financial instruments. The legislation does not provide any further guidance as to the content or intended application of these criteria.
Publishable Information Test (cont)

> The second aspect is identifying the class of persons who are likely to invest in the financial instruments whose price might be affected by the information.

> The information must be made known to a “cross section of the investors who commonly invest in the securities”.

> Further, the legislative language is explicit in that the class of investors is those who “commonly invest” in the relevant securities. This is broader than current holders of those securities, encompassing potential investors as well. As such, disclosure to the present shareholder base is unlikely to be adequate to render the information generally available under s 1042C(1)(b).
The second component of the publishable information test is that a sufficient period of time has elapsed for the information to be disseminated among the relevant class of investors.

At this point, it is worth noting that the disadvantage that small investors, presumably with no special access to inside information, is negated to an extent by virtue of s 1043M(2). That provision provides a defence to a person who trades on information where that person came into possession of that information purely by the information having been published in the manner described in s 1042C(1)(b)(i) (that is, in a manner likely to bring it to the attention of regular investors).
Information Analysis

> Here, a person has unique information, but that information was derived from information that falls within s 1042C(1)(a) and/or s 1042C(1)(b)(i).

> In other words, a market participant will not be brought within the insider trading provisions merely because they drew a conclusion that no one else drew (and traded based on that conclusion), so long as that conclusion was based on information that was readily observable or had been appropriately published.

> Further, there is no requirement that the information have been disseminated for any particular period of time. This arises from the fact that s 1042C(1)(c) draws upon s 1042(1)(b)(i) (the manner of publication requirement) but makes no mention of s 1042C(1)(b)(ii) (the dissemination requirement).
Material Effect

> Even if the information is not generally available, s 1042A also requires that, to qualify as inside information, the information needs to be reasonably expected to have a material effect on the company’s securities.

> Section 1042D provides guidance as to when information can be expected to have such a material effect on the price of the relevant securities. It states:

  - “For the purposes of this Division, a reasonable person would be taken to expect information to have a material effect on the price or value of particular Division 3 financial products if (and only if) the information would, or would be likely to, influence persons who commonly acquire Division 3 financial products in deciding whether or not to acquire or dispose of the first mentioned financial products.”
Material Effect (cont)

> The first aspect of this definition is that the test is an objective one, with its explicit reliance on what “a reasonable person” would be taken to expect.

> Second, the test is whether the information would be likely to influence a trading decision of a regular investor.

> There is no specific requirement that the information would have a particular effect on the security’s price (for example, the price would be expected to move by a minimum percentage).

> Consequently, it may be argued in appropriate circumstances that an expected effect that may be regarded as nominal and unlikely to be influential in one situation would be significant and influential in another scenario.
Material effect: The Citigroup Case

> The notion of material effect was considered in *Citigroup* on two occasions.
> The first of these was in considering the price sensitivity of the identity of the bidder in an expected takeover.
> The second occasion was in relation to information as to the timing of the takeover bid. There it was held that this information would be price sensitive within the test provided for in the legislation.
> A concerning aspect of this part of the judgment is its seeming reliance on hindsight. While on a careful reading, it is apparent that the court did reach this conclusion without depending on observed price movements, the reasoning moves straight into a short discussion of the price movements around the time of the relevant announcement to illustrate the information’s price sensitivity.
Deeming

> Section 1042G attributes the actions and characteristics of its officers to the body corporate for the purposes of the insider trading prohibition.

> “Officer” is defined in s 9 somewhat broadly and includes, as well as formal office bearers such as directors, a person who makes decisions affecting a substantial part of the corporation’s business, a person who has the capacity to affect significantly the corporation’s financial standing and a person with whose instructions the corporation’s directors are accustomed to act.

> This extended meaning of officer was considered in the Citigroup case, where the Federal Court held that, on the evidence before it, a trader with a daily limit of AUD 10 million was not in a position to affect significantly the corporation’s business so as to come within this definition.
Prohibited Conduct

> There are three forms of prohibited conduct under s 1043A – trading, procuring and tipping.

> To be affected by the prohibition, a person need only be in possession of inside information and knows (or ought reasonably to know) that that information is inside information.

> While the preceding analysis demonstrates that there are a number of matters that make identifying information as inside information less than clear cut in many situations, once the inside information has been identified as such, mere possession is enough to bring the holder within the prohibition. No other criteria, such as a connection with the company, are required.
Prohibited Conduct: Trading

- Section 1043A(1)(c) prohibits an insider from (whether as principal or agent) applying for, acquiring or disposing of relevant financial instruments. Insiders are also restrained from agreeing to engage in these forms of conduct.

- This is a narrower range of prohibited conduct than was the case under previous legislation, which also included offers and attempts to buy or sell securities.
Prohibited Conduct: Procurement

Section 1043A(1)(d) extends the prohibition on insiders against procuring another person to engage in the conduct identified in s 1043A(1)(c). Without limiting the meaning, the term “procuring” would otherwise be taken to have, s 1042F(1) includes inciting, inducing or encouraging an act or omission on the part of another person.
Prohibited Conduct: Tipping

> The prohibition against acts referred to as “tipping” is included in s 1043A(2).
> Here, an insider is banned from communicating the information (or causing the information to be communicated) to another person where the insider knows (or reasonably ought to know) that that other person is likely engage in conduct referred to in s 1043A(1) (that is, trade themselves or procure another person to trade).
> Note that, unlike s 1043A(1), the tipping prohibition also requires the relevant financial securities to be tradeable on an Australian financial market. Securities are still treated as being tradeable for the purposes of the tipping prohibition even if the issuing company has had trading in its securities suspended.
Exceptions and Defences

> The legislation provides for several exceptions and defences from liability and/or prosecution for breaching the insider trading prohibition in s 1043A.

> Under s 1043M(1), the prosecution is not required to prove the non-existence of any facts that would make out any such exception or defence.

> Consequently, the burden to prove these facts falls upon the defence, which, under the Commonwealth Criminal Code, must be proved on the balance of probabilities.
Exceptions and Defences (cont)

> The first exception is contained in s 1043B, which applies when a member of a registered scheme withdraws their investment.

> For the exception to apply, the amount paid to the member must be calculated with reference to the value of the underlying assets held through the scheme.

> Baxt, Black and Hanrahan explain that this exception is necessary to permit buyback covenants contained in unregistered schemes. This is because the responsible entity will at times predictably be in possession of inside information when required to redeem a member’s interests.

> Underwriters could potentially be caught by the prohibition in s 1043A(1) against applying for financial instruments while in possession of inside information.
Exceptions and Defences (cont)

> An exception is provided for parties who are required to acquire financial securities under a legal requirement Sections 1043F and 1043G provide for the Chinese wall defence for bodies corporate and partnerships respectively. Under s 1043F, a body corporate will not breach the insider trading prohibition by entering into a transaction or agreement at a time when an officer of the body corporate is in possession of inside information if:-

− The decision to enter into the transaction or agreement was made on behalf of the body corporate by a person (or persons) other than the officer in possession of the inside information;
− The body corporate at that time had in place arrangements that could reasonably be expected to prevent the communication of that inside information to the person (or persons) who made the decision to enter into the transaction or agreement; and
− The inside information was not actually communicated.
Exceptions and Defences (cont)

> The adequacy of Chinese walls within an investment bank was considered relatively recently in the *Citigroup* decision. The Federal Court there confirmed that, to be an adequate Chinese wall, the relevant policies do not have to meet “the practical impossibility of ensuring that every conceivable risk is covered by written procedures and followed by employees.”

> The defence available for partnerships available under s 1043G is structured in a similar way to that for bodies corporate under s 1043F.

> Section 1043H provides an exception where the relevant inside information is the insider’s knowledge of their own intentions. A similar exception is available for bodies corporate under s 1043I(1).
Exceptions and Defences (cont)

> An exception is provided for in s 1043J for officers of a body corporate who enter into transactions or agreements on behalf of their employer where the inside information is knowledge that the body corporate proposes or undertook transactions in relation to the financial securities of another entity.

> Section 1043K provides an exception for financial services licensees (and their representatives) where they trade on behalf of unrelated clients, so long as appropriate policies are in place to ensure that the inside information is not communicated to the principal and that no such communication took place.

> Finally, s 1043M provides for positive defences for allegations of a breach of the insider trading prohibition.
Penalties

> For individuals, the penalty is up to 10 years’ imprisonment and/or the greater of 4,500 penalty units and three times the amount of benefits derived (not necessarily by the defendant) that are reasonably attributable to the commission of the offense.

> For bodies corporate, the penalty for a criminal conviction is the greater of 45,000 penalty units and three times the value of the total benefits derived from the insider trading offense.

> If those total benefits cannot be valued, then the alternative penalty is 10% of the body corporate’s turnover in the 12 months ending in the month when the body corporate committed (or began committing) the offense.
Penalties (cont)

Civil penalties are provided for in s 1317E. The insider trading offenses are listed in ss 1317(1)(jf) and (jg), qualifying them as “financial services civil penalty provisions” as defined under s 1317DA. Under s 1317G, if convicted of an insider trading offense as a civil matter, a court may order an individual to pay a fine up to AUD 200,000 or a body corporate pay a fine up to AUD 1 million if the contravention of insider trading prohibition:

- Materially prejudices the interests of traders in the relevant financial products;
- Materially prejudices the issuer of the relevant financial products or, if the issuer is a corporation or a scheme, the members of the issuer; or
- Is serious.
Penalties (cont)

> Only ASIC can seek an order under s 1317E and, therefore, seek the penalties set out under s 1317G. ASIC must bring the civil action within six years.

> Section 1317HA also provides for compensation orders for damages suffered by another person (which may include a corporation) or a registered scheme.

> The court is empowered under s 1043N to relieve a person from any compensation order applicable under s 1317HA if the defences available under s 1043M are made out. Section 1317S provides additional avenues for the court to relieve a person wholly or partly from liability under s 1317HA in where the person has acted honestly and the court believes should fairly be excused for the contravention.

> As at May 2012, a “penalty unit” is defined in s 4AA of the Crimes Act 1914 (Cth) (for the purposes of Commonwealth offenses) as AUD 110. This means that the fine for a criminal conviction for an individual under s 1311 of the CA is AUD 495,000.
Enforcement: Institutional Arrangements

> The ASX and ASIC use the SMARTS surveillance system supplied by NASDAQ OMX. The SMARTS Integrity Platform is an extensive market surveillance solution consisting of 12 modules.

> The present division of responsibility can be summarised as follows: As stated, ASIC has responsibility for supervision of real-time trading on Australian domestic markets and is responsible for enforcing laws against misconduct on Australian financial markets.

> ASX Compliance Pty Ltd is responsible for monitoring and enforcing compliance with ASX operating rules. Matters arising before the transfer of responsibility for market supervision to ASIC on 1 August 2010 are referred to the Disciplinary Tribunal. Matters arising after 1 August 2010 are referred to the ASX Chief Compliance Officer.

> The ASX is obliged under the Corporations Act 2001 and pursuant to a Memorandum of Understanding with ASIC dated 28 October 2011 (available at the ASX website) to notify ASIC of various matters including any suspected contraventions of the Corporations Act or the operating rules. Information about the number and type of referrals made by ASX to ASIC are published in the ASX Compliance Monthly Activity Report.
Enforcement: Market Supervision by ASIC

> The Market and Participant Supervision Unit at ASIC comprises four teams: real-time market surveillance; relationship management; participant compliance and market analysis. The market surveillance team uses SMARTS technology and contains several former ASX personnel.

> Preliminary analysis of a suspected insider trading matter is done by the real-time surveillance team, the misconduct and breach reporting unit and the participant compliance team. The matter then proceeds to the market analysis team for further assessment and a recommended course of action which may include a referral to a deterrence unit for investigation.

> ASIC deterrence teams contain former ASX investigators. For example, the deterrence team dedicated to market integrity matters was built around staff from ASX investigations and enforcement units. A “Triage Committee” then prioritises matters and, where appropriate, the markets deterrence teams at ASIC take matters to court.
Enforcement: Enforcement by ASIC

> ASIC’s approach to enforcement appears in Information Sheet 151. ASIC states strategic priorities include confident investors and fair and efficient financial markets.

> ASIC will use deterrence to achieve its strategic priorities in cases of serious misconduct which impacts on market integrity or the confidence of investors and has serious consequences for investors.

> ASIC has the option of pursuing civil penalties or referring criminal offence to the Commonwealth Director of Public Prosecutions (DPP).

> Criminal prosecution is reserved for the most serious misconduct such as insider trading where the maximum penalty is up to ten years.
Concluding Remarks

> The preceding analysis demonstrates that Australia has, for the last 20 years, a particularly broad prohibition against insider trading, as measured by world standards.

> The essential component of this claim is the definition of insider in s 1043A, which looks only to the possession of inside information.

> Compared with most other jurisdictions, which usually require some form of connection to the issuing company, Australia may be regarded as having one of the broadest, if not the widest prohibition in the world.
Concluding Remarks (cont)

> Despite the longevity of the current regime, a degree of uncertainty still exists around particular elements of these provisions.

> In particular, aspects of when information is to be considered generally available and what constitutes sufficient dissemination have caused problems in the past and are likely to continue to do so.

> Given the severe penalties associated with breaching the insider trading provisions, which includes up to 10 years’ imprisonment for individuals, it is reasonable to expect that the boundary between acceptable and unacceptable behaviour be drawn more clearly.
Concluding Remarks (cont)

> Alternatively, this vagueness may cause the courts to err on the side of caution and construe the provision in a defendant-friendly manner (consistent with the overriding innocent until proven guilty standard in criminal prosecutions).

> Such an outcome will inevitably lead to claims from the regulator, as has been seen in the past, that the prohibition is unenforceable in its current form and needs to be strengthened further.

> Either way, it is safe to conclude that Australia’s insider trading provisions are likely to see further reform.
Enforcement Puzzles

> NZ insider trading regime same as Australia as of 2008.
> No prosecutions under the 2008 regime.
> No detailed analysis but Malaysia and Singapore have few prosecutions.
> Why the enforcement deficit?
> For discussion, see the chapters on Australia and New Zealand in Stephen Bainbridge, ed, Research Handbook on Insider Trading (Edward Elgar, 2013) by Walker et al.