AFMA RESPONSE to the CAMAC INSIDER TRADING PROPOSAL PAPER

1.0 Introduction

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

· AFMA FSR Task Force
· AFMA Electricity & Energy Committee

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

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

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

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

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

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

2.0 Chapter 1: Financial Markets Transactions

2.1 Competitive neutrality and harmonization

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

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

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

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

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

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

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

2.2 Risk transfer of OTC financial markets

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

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

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

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

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

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

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

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

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

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

2.4 Impact on Australia as a centre for financial services

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

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

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

2.5 Market Arbitrage

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

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

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

2.6 Misuse Requirement

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

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

3.0 OTC Financial Markets Policy Options (section 1.68)

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

Each of the options is considered below.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

4.0 AFMA's preferred position regarding the position paper options

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

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

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

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

5.0 Conclusions.

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

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

The Australian Financial Markets Association commends the CAMAC insider trading Proposal Paper. AFMA would like to reinforce that the solutions to the insider trading issues must be implemented quickly. AFMA encourage CAMAC to strongly promote

that early amendments are critical to protect the Australian financial services industry and the public.

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

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