

The Australian Institute of Company Directors

The Australian Institute of Company Directors (AICD) is the peak organisation representing the interests of company directors in Australia. Current membership is over 16,000, drawn from large and small organisations, across all industries, and from private, public and the not-for-profit sectors. Membership is on an individual, as opposed to a corporate basis.

The AICD is a federation of seven State divisions, each of which is represented on a National Council. Overall governance of the AICD is in the hands of its National Council which is comprised of the seven division Presidents, plus a National President, two National Vice-Presidents and a National Treasurer. AICD has several national policy committees, focusing on issues such as law, accounting and finance, environment, taxation and economics, and national education, along with task forces to handle matters such as corporate governance.

The key functions of AICD are:

- to promote excellence in director's performance through education and professional development
- to initiate research and formulate policies that facilitate improved director performance
- to represent the views and interests of directors to government, regulatory bodies and the community
- to provide timely, relevant and targeted information and support services to members and, where appropriate, government and the community
- to maintain a member's code of professional and ethical conduct
- to uphold the free enterprise system
- to develop strategic alliances with relevant organisations domestically and internationally to further the objectives of the AICD

AICD appreciates the opportunity to make submissions on the Discussion Paper (“DP”), and commends CASAC for reviewing Australia’s insider trading legislation in the light of corresponding legislation of comparable countries, a valuable summary of which is contained in DP Appendix 2.

AICD comments on the issues raised in the DP follow the DP’s grouping of those issues into:

- matters that should not be changed
- matters that may require legislative change
- other possible changes for consideration.

Matters that should not be changed

Who are insiders?

The DP notes in para 0.17 that “in almost every respect, the Australian insider trading laws are stronger in their terms than comparable overseas laws”. That observation is particularly pertinent to the definition of an *insider*. Whereas the law of almost every comparable jurisdiction requires an *insider* to have some kind of connexion with the relevant company, in much the same way as Australian legislation did before 1991, present Australian legislation makes a person an insider merely by the possession of price-sensitive information that is not generally available, howsoever obtained, regardless of:

- any connexion or lack of connexion with the relevant company
- the propriety or lack of propriety in obtaining the information.

AICD submits that CASAC should re-consider whether Australian legislation should, in that respect, be brought more into line with that of almost all of the other jurisdictions as outlined in DP Appendix 2. AICD would draw the attention of CASAC to the following considerations:

- the target of the prohibition against insider trading is the improper use of information by persons having a privileged access to information: that, if anything, is what the notion of *market fairness* is all about
- it is unfair to prohibit a person from profiting from information obtained by the person’s own discovery and not derived “from within [the relevant] company.”
- it does not advance the government’s professed objective of making Australia a major financial market in the world by casting its insider trading legislation in a mould which, in this regard, would be seen to be unfair in comparison with that of other comparable jurisdictions

In its definition of an *insider*, Australian legislation - as the DP appears to see it - contemplates a market that is both *efficient* and *fair* in the sense of being a market in

which all participants are in possession of all relevant information at any relevant time. No market in the real world functions, or is capable of functioning efficiently on that basis.¹

One does not have to go all the way with Professor Henry Manne in taking that point what he sees as its logical conclusion: that, far from prohibiting *insiders* from trading, they should be encouraged to do so to promote market efficiency. One cannot, however, close one's eyes to the reality that the objective notion of *market efficiency* and the subjective notion of *market fairness* are to a degree in conflict. Very arguably, Australia's present legislation pursues unduly the objective of *market fairness* at the expense of *market efficiency*. AICD therefore submits that consideration be given by CASAC to recommending the re-definition of an *insider* along the lines recommended by Professor Philip Anisman in his report to the NCSC *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives*.²

Such a definition would:

- confine the notion of *insider* to a real insider including, be it said, a director of the relevant company and a tippee from a real insider
- bring Australia's insider trading law more or less into line with comparable jurisdictions
- strike an acceptable compromise between the notions of *market efficiency* and *market fairness*
- avoid the complexity of the pre-1991 requirement of *connexion*, which so troubled the Griffiths Committee whilst at the same time meeting its fundamental point that "The offence of insider trading must have its genesis in the use of information derived from within a company."

Underwriting exemption

The Institute supports retention of the exceptions for underwriters presently contained in CA s1002J for:

- communication of information to underwriters
- subscription of underwriters
- on-selling by underwriters

The DP supports retention of the first two, but questions retention of the third. Removal of the third exemption would necessarily increase underwriting risk and would consequently increase underwriting fees or decrease underwriting availability. AICD therefore supports retention of the on-selling exemption and notes that it does not appear to have caused any trouble since its introduction in 1991.

¹ See, for example, F. A. Hayek *The Use of Knowledge in Society*.

² AGPS Canberra 1986

Matters that may require legislative change

Information covered

The Institute supports an amendment to exclude information that relates only to securities generally or to issuers of securities generally.

Generally available information

The DP's concern about the decision of the NSW Court of Criminal Appeal in *R v Firms*³ that a judgment of an open Papua New Guinea court is *readily observable matter* for the purposes of Australian insider trading legislation is understandable, but the Institute fears that the cure proposed by the DP, viz:

giving priority to the publishable information test by confirming the readily observable matter test to anything not capable of falling within the publishable information test

could prove to worse than the supposed defect. And it would certainly do violence to the legislative intention of the *readily observable matter* arm of the definition of generally available information, expressed in paragraph 326 of the explanatory memorandum for the current insider trading legislation as follows:

Concern was expressed that in consequence of the adoption of the definition [the publishable information test] in the exposure draft, information directly observable in the public arena would not be regarded as generally available, as it has not been "made known". It was considered that a person could be liable for insider trading where he/she traded in securities on the basis of, for example, an observation that the body corporate had excess stocks in a yard. This was not the intention of the provision.

Is such an observation "capable of falling within the publishable information test? If so, who would publish it and how?

Transactions covered

AICD supports:

- introduction of a rule similar to SEC Rule 105b5-1 to permit persons to deal in securities in accordance with securities trading plans entered into without possession of unpublished price-sensitive information
- permitting an option holder who becomes aware of unpublished price-sensitive information after entering into the option contracts to exercise the option to buy or sell, provided that the option contract stipulates a fixed exercise price

³ [2001] NSWCCA 191; (2001) 38 ACSR 223

Internal controls over insiders

As already noted, AICD supports retention of the *Chinese Wall* exception for corporations and partnerships. AICD also supports extension of the exception to the procuring offence.

Director notification of shareholdings

It is imperative that there be no inconsistency in the notification provisions of the Corporations Act and the ASX Listing Rules. If a legislative change is to be made, it should clearly override and supplant the ASX Listing Rules on director notification. The worst outcome for Directors would be to have two slightly different notification obligations.

Other possible changes for consideration

Liabilities of insiders

AICD does not support amending the legislation to:

- prohibit insiders from disclosing inside information without a lawful reason, even where the purpose or result of the disclosure is that the recipient does not trade
- require a person lawfully disclosing inside information to inform the recipient that the information is inside information
- impose liability on insiders for procuring if, on the basis of inside information, they “discourage or stop” another person from dealing in affected securities

The first two of those proposals would be seen by many to amount to an unwarranted assault on freedom of speech. The third does not strike AICD as very logical. As the DP points out at para 1.77, an *insider* may lawfully use inside information for the purpose of refraining from trading. Why, therefore, should it be an offence to communicate inside information to encourage someone else to refrain from trading?

Transactions covered

The *Financial Services Reform Act 2001* (“**FSRA**”) re-enacts existing insider trading legislation presently in Part 7.11 Div 2A with little change, apart from extending its operation beyond *securities* to *Division 3 financial products*, defined in s1042A as meaning:

- securities
- derivatives
- managed investment products
- superannuation products, other than those prescribed by regulation
- any other financial products that are able to be traded in a financial market

AICD agrees with the DP's suggestion that the legislation be confined to securities and other financial products that satisfy any of the following tests:

- they are traded or are capable of being traded in a financial market
- they give an indirect interest in a tradeable financial product
- they involve a financial services provider

As the DP points out, insider trading does not apply to trading in commodities, and it would therefore be anomalous to apply it to derivatives over commodities.

Subjective elements

AICD opposes the DP's suggestion that the legislation could introduce a rebuttable presumption that directors and other managers are aware of any confidential price-sensitive information derived from within their companies or a rebuttable presumption that they are aware that information of that kind is "inside" information. Such presumptions would often be factually incorrect and would be inherently unfair.

To say that such presumptions would assist insider trading prosecutions is much the same as saying that a presumption of *mens rea* on the part of the accused would assist murder prosecutions.

Exemptions

Contrary to the position taken by the DP, AICD believes not only that the present exemption for liquidators, personal representatives and trustees in bankruptcy should be retained, but also that it should be extended to other external administrators. An external administrator's task is quite difficult enough without having to worry about insider trading legislation and, as the DP notes, an external administrator does not make any personal gain from transactions entered into in that capacity.

Derivative civil liability

AICD opposes the suggestion in the DP that a person who is in a position to control or supervise the activities of another person be civilly liable where that other person on his or her own behalf breaches the insider trading provisions.

The DP points to US legislation which imposes such derivative civil liability - in some circumstances. Whatever the merit or otherwise in the US of that approach, it must be remembered that US law requires a person to have a fiduciary or similar duty to the relevant company, a matter which could be expected normally to be known to a controller or supervisor. To impose such liability under Australian law, with its egregious notions of *insider* and "inside" information would be most unjust.

Takeovers

AICD agrees with the suggestions in the DP that:

- 0.49 Any exemption for pre-bid buying by a consortium contemplating a takeover bid might only apply to any purchases made on behalf of that

consortium. Individual consortium members should not otherwise have an exemption.

- 0.50 Target company directors could have a defence to the disclosing and procuring offences if they show that they communicated any inside information merely for the purpose of encouraging a person to be a white knight and took all reasonable steps to ensure that the white knight did not transact an issued target company shares before that information became generally available.

Regulator's remedies

AICD opposes the introduction of a provision for recovery of a multiple of the profit gained or loss avoided in insider trading, or giving ASIC power to impose administrative penalties.

As the DP points out (para 3.4) the FSRA has made the insider trading provisions civil penalty provisions, empowering the court to make various civil penalty orders, including:

- a declaration of contravention
- a pecuniary penalty order of up to \$200,000
- a compensation order for any person who has suffered loss or damage through a contravention

AICD does not consider that further measures should be put forward until it appears clearly that the new civil penalty regime is inadequate.

Liability of procured persons

The FSRA replaces the civil liability provisions in CA 1013 with a new s1043L. The position of a person who is unknowingly procured to buy or sell by an *insider* is in principle unchanged: that person remains under potential civil liability. The essential unfairness of such liability leads AICD to support the DP's suggestion of relieving a person in that situation from civil liability, provided that the *insider* did not receive any direct or indirect benefit from the transaction.

Compensation rights

The DP (paras 3.36 - 3.43) points out the difficult questions arising from giving compensation rights for insider trading. As AICD sees it, the questions have been pre-empted by the new civil penalty regime introduced by the FSRA, which allows compensatory orders for any person who has suffered loss or damage through a contravention of, *inter alia*, the insider trading legislation. The legislature has left it to the courts to grapple with the difficult questions, and further legislation should therefore await the courts' work on the task entrusted to them.

Speculative trading by insiders

The DP raises the suggestion that *directors and other corporate decision makers* should be prohibited from short selling their companies' securities or transacting in options over them.

The suggestion arises from Canadian legislation to that effect (DP paras 4.15 - 4.18). AICD finds difficulty, having regard to Australia's different legislation both on insider trading and short selling, in seeing justification for such legislation.

Prohibition on short selling profits

The DP suggests that *directors and executive officers* should be required to disgorge any profits received from buying and subsequently selling their company's securities with a six month period.

This suggestion is prompted by US legislation to that effect. It assumes that directors and executive officers are always and inevitably in possession of unpublished price-sensitive information, an assumption which is not legitimate. This assumption if taken to its logical conclusion, would justify prohibition of any dealing by directors and executive officers in their company's securities irrespective of possession of unpublished price-sensitive information. The suggested period of six months is entirely arbitrary.