Subject: Comments on Insider Trading Discussion Paper

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Comments on Insider Trading Discussion Paper

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We appreciate the opportunity to review and comment upon the Insider Trading Discussion Paper (the "Paper"). We have tried to be as succinct as possible, and to restrict our comments to the topics listed below, where there were specific issues which

we wished to raise, orw here we agreed or disagreed strongly with the positions taken in the Paper.

We do hope that these comments will prove useful. We would, of course, be happy to discuss any of the comments, should the need arise.

Comment #1- "Information Connection" Approach

This seems to be an essential preliminary issue to inside trading regulation. It appears to us to be valid to begin regulation with an "information connection" approach, effectively catching any person or entity with undisclosed material price-sensitive information about a company, without regard to the relationship of such person to the company, or the source of such information. We also agree with the proposed strengthening of the "generally available information" provisions. The broader focus of an "information connection" would correctly sweep into the insider trading net activities such as "front running" and "scalping", since the information on which these activities would be made profitable is itself material price-sensitive information not sourced in the company whose securities are being traded.A dapting such an approach will require consideration of a broader range ofr elationships which must be exempted from regulation, since the approach will automatically sweep into the regulatory prohibition a number of relationships which, arguably, should not be caught. This approach appears to us to be marginally preferable to regulation through a "people connection", where itw ould be necessary to define the connections to a company that will bring the possessor of information within the scope of the regulation, instead of defining the situations which require exclusion under the "information connection"a pproach. This is because the "information connection" approach should be more flexible, and should catch a broader array of misuses of non-public information. However, since failure to comply with this regulation is meant to have criminal or quasi-criminal repercussions, it may be overly-protective and too inflexible to catch all possible future uses of inside information, no matter how developed, unless exempted by future legislation.

This issue becomes more significant in the context of comparison with insider trading regulation in other major capital markets, and the increasing globalization of international equity markets. As the Paper points out, allo ther markets, with the exception of Malaysia, (the Province of Quebec, Canada is another example) have a "people connection" component to insider tradingr egulation. It may become a disincentive to inter-listing of internationale quities on the ASX if Australian insider trading laws were seen to criminalize behavior related to trading activities when these same activities would not be caught in jurisdictions having a "people connection" test, and may be sensibly excluded.

While we tend to favour the "information connection" approach, we do have a lingering concern about catching in the broader trading net activities which should not be caught, and are not caught in other jurisdictions. We wonder if this perceived

difficulty might not be addressed by some broad regulatorye xempting power in the hands of ASIC, which could be used, prospectively and retrospectively, to exempt types or varieties of trades as future circumstances require.

Comment #2- **Clear Deliniation of the Prohibition**

It is always difficult to advise in an area where the boundries of prohibited activity are imprecise, particularly so when the prohibition carries criminal or quasi-criminal sanctions for breach. The Paper recognizes this issue in itsi ntroduction (section 0.5), where it is stated that "Insider trading laws also need to be clear and workable, so that all parties know where they stand." Yet the basis for responsibility for insider trading involves trading while inp ossesion of something as imprecise as "material price-sensitive information". It is not hard to imagine that corporate insiders will always be in possesion of some non-public information, even after announcement of the latest financial period results. This will cause some measure of uncertainty with these individuals trading, even under the best of circumstances, lest after the fact it be argued that such information was materially price-sensitive because its announcement would have moved the market by some small percentage.

We believe it would be helpful if some indication was given as to the magnitude of what is "material" price-sensitive information. This would at least give some comfort to consciencious insiders in affecting ordinary trades, and make advising in such circumstances marginally easier.

Along a similar line of thought, it would be helpful if some guidance could be given as to what is a "reasonable dissemination period" following which an informed person can trade after public disclosure. Again, the issue is giving comfort to the conscientious insider, or advising such insider. Possibly, the answer is that an informed person can trade as soon as the market re-opensf ollowing release of confidential information. Yet, the insider has had time to digest more fully the impact of the announced change, and thus may still have an advantage on the market for some unknown period. Some "bright-line" guide as to what is a reasonable dissemination period would be very helpful, yet would not seem to be at odds with any regulatory objective.

Comment #3- Application to Non-Publicly Trade Securities

It is hard to see the rationale for extending the reach of insider trading to securities that are not publicly traded. Certainly, there can be no need to protect the integrity of capital markets in prohibiting such trades. To a business venture, one of the costs of access to public markets is the accompanying duty of public disclosure. We wouldn't have thought that if there is no duty of continuousm aterial change disclosure, there is any

need to have insider trading implications for selling non-traded securities without disclosure.

Sales of significant interests in private companies are normally attended by heavily-negotiated disclosure provisions, coupled with indemnities forb reach. These are normal commercial provisions which are privately negotiated. Causing insider trading ramifications to flow from such transactions wouldc reate in effect a positive duty of disclosure on the seller, as the only way of obtaining a suitable equal knowledge defence. This seems to us to be an unwarranted interference in private commerce, with no corresponding publics ecurities regulation policy objective being served.

Comment #4- New Issues Of Securities

Similar to comment #3, it is difficult to understand why insider trading rules should be extended to new issues of securities. When new issues are undertaken through prospectus, the purchasers have a whole separate set of rights flowing from incomplete prospectus disclosure,i ncluding rights against the issuer, its directors, and others. The need for additional penalties under the insider trading rules seems doubtful at best.

If securities are being issued in a private placement transaction,w ithout benefit of a prospectus, the assumption has to be that private placees can negotiate their own sets of representations and indemnities to guard against the risks that they consider material. Even if a need was felt to exist to protect purchasers in prospectus-exempt transactions, it would seem more compatible to the scheme of securities regulation generally to give such purchasers private rights of action for incomplete disclosure (based on some less formal disclosure document such as an offer information statement, offering memorandum or circular) then to apply the full range of insider trading provisions to such private failures of disclosure.

It must be remembered that insider trading is a very serious default, with criminal and quasi-criminal consequences. It would seem inappropriate that such dramatic results should flow from disclosure failures in a share issuancet ransaction, where other more appropriate remedies exist.

Comment #5 - Tipping/ Procuring

It would probably be simpler and more effective to prohibit all tipping of inside information, whether there is or is not a reasonable expectation of trading, unless the tipping was in the necessary course of the business of the company for which the information is price- sensitive. This exception would, of course, have to be carried through to the permitted uses that can be made of price-sensitive information derived from outside a company (i.e. developed by analysts). The requirement that the tipping

of price-sensitive information be accompanied by a disclosure that the information is non-public and cannot be used to trade would certainly improve the ability to track the party in the chain responsible for misuse, that being either thep erson who traded after receiving disclosure that the information was non-public, or the person who tipped and failed to disclose that the information was non-public and price-sensitive.

Consistent with the above, a procuring offence should be made out simply by the advising by the person with the special knowledge to trade or not tot rade, whether a trade occurs or whether the person informed is aware that the advisor possesses inside information. It may be that it will be difficult to prove the procuring when no trade occurs, either because the actual advise is not accepted or the advice is not to trade. However, the wrongful use of inside information still exists in these circumstances, and the clean articulation of the prohibition should act as a deterrent in most cases. In at least some situations, the offence will still be provable, as where the person who receives the advice is prepared to speak.

As to the responsibility of the person procured, that person should be an insider, with separate responsibility, if he or she knows, or should reasonably know, that the advisor possesses inside information (whether the exact detail is known), but should have no actual or implied responsibility if there is nok nowledge of any wrong being committed by the advisor

We suggest that the above is a cleaner and simple set of rules morec onsistent with the general concepts of an "information connection" system.

<u>Comment #6</u>- Take- Over Bids and White Knights

Consistent with the above comment, we believe that a company should be able to convey material price- sensitive information to a white knight to induce a rival take- over bid, and that this tipping would be in the necessary course of the company's business. That information would have to be conveyed subject to an indication that it wasm aterial undisclosed information, and could only be used to make an all-shares offer through which the substance of the insider information would be conveyed by the bidder. We believe that these disclosure procedures are already normal for such transactions, and would probably be the only basis upon which directors and officers of the targetc ompany could meet their fiduciary obligations to act in the best interest of the company and all of its shareholders in disclosing valuable proprietaryc orporate information.

The more difficult question in this area is whether either an original bidder or a white knight should be able to make pre- bid purchases under an" information connection" insider trading regime. A credible argument can certainly be made that the fact that a bid is intended is itself material price-sensitive information. If that is so, why should either bidder be allowed to use such information to acquire shares in advance of a bid

in a regime which attaches significance to the possession of price- sensitive information, however generated?

Of course, regulating pre-bid accumulations by a bidder would be contrary to market practice in other jurisdictions, and may cause serious issues forb idders in inter-listed shares, in a manner similar to that mentioned in Comment #1. If a bidder is allowed to bid, an explicit exemption would appear to be necessary. If this approach is taken (and we think that consistency to international standards here is probably preferable top urity with the "information connection" concept), there would seem to be little justification to extending it to permit purchases by individual bidding syndicate members, rather than exempting purchases only on behalf of the bidding syndicate. As a final matter, there should be no impediment to the white knight making pre-bid purchases as well, as long as the white knight has not received advice that it has been given material non-public price-sensitive information about the target company. It would only be the receipt of such information which should disqualify pre-bid purchases, and not the status alone of being a second bidder in a take- over battle.

It could even be argued that the receipt by the white knight of information that another bid was expected might not disqualify the white knight from making market purchases if it has already agreed with the company to make its own bid. Presumably, the white knight's bid will have to be higher than the original proposed bidder to be successful, and thus the news of the original bidder's intention would not appear to be material. Allowing the white knight to accumulate would level the playing field between the bids, by letting botha ccumulate, to the ultimate benefit of all shareholders, who would presumably have the benefit of the full inter-bid competition.

Comment #7 - Exemptions

In a system based on "information connection", which sweeps up all holders of price-sensitive information, creating the right balance of exemptions, or carving out types of information which may well not be regarded as material price- sensitive information, is probably the most difficult issue of all.

As set out above, we believe that on a balance of interests, an exemption for take- over bidders who do not have non-public material information, other than their own intention to bid, makes most sense, and perhaps can even bee xtended. Also, the underwriting exemption makes sense if new share issues are to attract insider trading implications, despite our Comment #4. The sense of this exemption would have to be that the underwriter has been informed about the non- public information and thus there is an equality of information between vendor and purchaser. An exemption for risk passage from the underwriter to a sub-underwriter, on the basis that the underwriter wouldd isclose prior to contract, also makes sense. In each of these cases, the assumption would have to be that the required tipping by the company to the underwriter, and from the underwriter to the sub-underwriters, would be permissible as in the necessary course of the company's business, and would be accompanied by non- trading

warnings, permitting trading only after delivery of the disclosured ocument which would accompany the ultimate sale and which would contain the until then non- public information.

On the other hand, we agree that an exemption for scheme managers,r eceivers, administrators and liquidators makes no sense. If these entities actually possess material non-public information, they should not be permitted to trade until disclosure has been made. There would seem to be no conceivable public market rationale for preferring thei nterests of the creditors of the company to the interests of participants in the public capital markets.

We also agree that the "did not make use" defence is inappropriate in that it can give rise to exemptions that are not based entirely on reality. Trading decisions can result from more than one factor, including the non- public information. Engaging in an examination of whether the non- public information or another reason is the predominant motivation for a trade is unproductive, and probably contrary to at least the appearance of fairness in the capital markets. A more rigid exemption based upon a non-d iscretionary trading programme, implemented prior to receipt of the material non- public information, makes more sense.

We also agree with the position that an exemption for trading based on an analyst's report should be limited to research resulting from deduction, conclusions and inferences made or drawn from generally available information. If the analyst's report is based on access to corporate secrets, either verbal or documentary, the report should be considered as tipped information, and thus unusable without insider trading implications. Trading in front of the release of an analyst's report should also be prohibited on the basis that the report, even if based on generally available information, may itself be material non- public information. The difficulty with this last conclusion is that if it is correct, then the release of the report to a selected dealer's client list, for solicitation of trading orders, would also have to be tipping. If so, the analyst could never engage in analysis which could be valuable to the dealer's trading clientele until after broad disclosure. Perhaps the answer here is in fact a specific provision making this" scalping" activity into insider trading, but specifically exempting the conveying of the recommendations to clients, and subsequent trading by these clients.

We believe that insider trading should apply to more than individuals (i.e. it should apply to a corporation or partnerships trading on its own behalf, or tipping or procuring), and that it should be presumed that information contained in one part of an organisation is available in another part of an organisation which then trades, advises or procures. The obvious conclusion from the above is that a Chinese Wall defence is still necessary. The problem with Chinese Walls is that more and more, there is scepticism as to whether the Wall really works tos egregate the non- public information from those who trade. The way in which S.1002M and S.1002N are currently drafted grants the exemption only if "the information was not soc ommunicated and no such advice was so given". Thus, the organisation wishing to rely on the exemption would appear to have the onus of proving that the Wall actually works if a situation deserving

of testing should arise. It appears to us that this statement of the exemption sufficiently protects a truly functioning Wall, and still allows for attack on the leaky Wall. We thus think that no change needs to be made here, other than specifically addressing procuring activity to ensure that it also is protected as long as the Wall works.

Comment #8 - Civil Liability To Market Participants

We believe that the criticism is rightly made that the current civila ction by a market participant against an insider trader is not useful. This is because of the difficulty in matching trades to the insider, and also because any matching is fortuitous. We do not, however, see any real virtue in moving to a regime that allows forc ompensation to be paid to those who are contemporaneous traders in the market. Again, the fact that these participants were in the market in the period contemporaneous with the insider is purely fortuitous. One has to assume that these people were buyers or sellers in any event and would have transacted with someone else at the same price if the insider was not in the market, unless the insider was running the market up or down (which seems highly unlikely, as the insider would then be clearlyb egging to be caught). Thus, there would appear to be little utility in such compensation. Any deterrent factor from the threat of compensation would appear to be unnecessary as the activity is already criminal, and subject to heavy civil penalty. The other problem with contemporaneous matching is the potential sheer magnitude of the liability. Consider the office worker who uses inside information to purchase 500 shares. On an order- matching civil liability, this person's civil liability would fit the magnitude of the offence. What would be thel iability potential for this offender under a contemporaneous trading regime?

Similarly, it is hard to imagine real utility in the company itselfh aving rights to pursue a civil action. One would assume that to do so, the company would have to establish its own losses, which, as the Paper points out, are difficult to imagine as existing.

Comment #9 - Insider Reporting

We believe some care should be taken in extending insider reporting obligations too far, unless some "material change" threshhold is applied. In many modern organisations, mid- level management individuals are often given titles such as "vice-president" as am eans of recognition, but without the title conveying the sense of someone in continuous possession of real inside information. Occasionally, such people may actually possess inside information, but more routinely they do not.

As often, the remuneration package of these mid- level managers includes option or share compensation entitlements, and if the company is doing well, those equity assets may be the individual's largest source of wealth accumulation. It is only with a great deal of actual embarrassment that these individuals can liquidate ap ortion of their holdings, for very valid personal reasons, and without any hint of inside trading, if a

reporting obligation is involved. As more "juicy" information becomes available in public insider reports, the gossip side off inancial reporting will run newspaper columns reporting which insiders have sold. This then becomes an issue for the mid- level manager, both inside the organisation where he or she may be seen as not believing in the cause, and outside, where personally sensitive information is made public.

The point to this is that there may be little marginal utility to extending insider reporting to these levels, but quite significant personald is benefit to the individual. Either the reporting obligation should be kept to real senior officers, or a "material change" level should be put into the reporting obligation in order to balance the reporting benefit with the obligation on the insider.

Comment #10 - Short Swing Profit Rule

This is a provision of American securities laws that would best be left where it is. The Rule is simply a great annoyance to shareholders and executives of public companies, with arguably no utility to the market. It presupposes that buys and sells in a six-month period must be improper, which clearly is not necessarily so. The only utility to the Rule lies in the American willingness to permit private enforcement actions, which allows securities bounty- hunters to perform searches to try to be first to identify a possibly unintentional infringement of the Rule, for personalp rofit to the securities sleuth. It is hard to imagine why Australia would want to import this, possibly the worst of American securities regulation.