NEW LAWS TO HELP STOP THE CHEATS

INSIDER TRADING: A MILLION-DOLLAR OFFENCE

The Corporations Legislation Amendment Bill 1991 contained sweeping changes to the insider trading provisions in Chapter 7 of the Corporations Law. These changes became law on 1 August 1991. Those who deal in securities need to be aware of the new provisions, as the penalties for breach can be significant.

The new insider trading provisions apply to acts or omissions in Australia in relation to securities of any body corporate (including a foreign body corporate); and to acts or omissions outside Australia in relation to securities of a body corporate that is formed, or carries on business, in Australia (Section 1002 of the Corporations Law).

What is insider trading?

Under the new provisions, an insider must not (whether as principal or agent):

(a) subscribe for, purchase or sell, or enter into an agreement to subscribe for, purchase or sell, securities of a body corporate in respect of which the insider has inside information; or

(b) procure another person to do (a) above: s.1002G(2).

Procuring includes inciting, inducing or encouraging: s.1002D.

Further, if the relevant securities are listed, the insider must not, directly or indirectly, communicate inside information or cause the information to be communicated to another person if the insider knows, or ought reasonably to know, that the other person would or would be likely to do (a) or (b) above: s.1002G(3).

Each of the italicised expressions is given a wide definition in the new insider trading provisions.

Who is an insider?

A person (which includes a group of persons carrying on business in partnership and a body corporate) is an "insider" if he, she or it possesses inside information about securities of a body corporate and knows, or ought reasonably to know, that the information is inside information: s.1002G(1).

It is no longer necessary, as it was under the former law, for the prosecution or a plaintiff to show that the insider acquired the inside information by reason of a "connection" between the insider and the body corporate in whose securities the insider dealt.

So, for example, a person who

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receives inside information because he or she has overheard a conversation in a restaurant or was sent a fax by mistake can be an insider, even though the information was received innocently and by accident.

What are securities of a body corporate?

The term “securities of a body corporate” is defined to include:

- shares;
- debentures (including convertible notes);
- prescribed interests;
- “units” of shares or prescribed interests; and
- options to buy or sell the above (including exchange-traded options); s.1002A(1).

It also extends to cover securities of a government, unincorporated body or other person as if it were a body corporate: s. 1002A(2). This would include, for example, government bonds.

The new insider trading provisions thus close some of the gaps in the coverage of the former law, which did not include exchange-traded options or government securities and, arguably, did not cover prescribed interests.

Futures contracts, which are the subject of a separate insider trading regime in Part 8.7 Division 1 of the Corporations Law, are specifically excluded from the definition of securities of a body corporate.

Because of a drafting error in the definition of securities, it would seem that the new insider trading provisions do not apply to options granted by a body corporate to subscribe for shares. This deficiency has been brought to the attention of the ASC and one can expect to see it corrected in the not-too-distant future.

What is inside information?

Inside information is information which is not generally available but which, if it were generally available, would be expected by a reasonable person to have a material effect on the price or value of securities of a body corporate: s.1002G(1).

Information includes matters of supposition and matters insufficiently definite to warrant being made known to the public; and matters relating to the intentions or likely intentions of a person: s.1002A.

Information is generally available if it consists of readily observable matter; or

- it has been made known in a manner that would, or be likely to, bring it to the attention of persons who commonly invest in securities of the relevant kind (and a reasonable period has elapsed after it has been made known); or
- it consists of deductions, conclusions or inferences drawn from the above: s.1002B.

A reasonable person is taken to expect information to have a material effect on price or value if it would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe, buy or sell: s.1002C.

These provisions are not without their difficulties. For example:

- The definition of “information” is extremely broad. Arguably it is wide enough to catch an inference drawn by someone who sees the managing director of A (which is known by the investment community to be “cashed up”) lunching with the managing director of B (which is known by the investment community to be under threat of a takeover and in search of a white knight) that A and B may be exploring a potential merger.
- What are the ways in which information can be disseminated so that it is brought to the attention of persons who commonly invest in securities? They clearly include a press release, an announcement to the ASX or an announcement on the Reuters screen service. It probably includes a presentation at a general meeting of shareholders or to a large number of institutional investors. It probably does not include a presentation to a small number of brokers and analysts, even if they then use the information they receive to prepare research reports for circulation to their clients.
- Who falls within the class of persons who commonly invest in securities of bodies corporate? Is it limited to institutional investors, brokers and the like? Or, in the case of stocks such as BHP, Commonwealth Bank and some of the other blue-chips, would it extend to “mums and dads” who in fact do commonly invest in such stocks?
- What is a reasonable period for information to be disseminated among persons who commonly invest in securities? In the case of an announcement to the ASX, could it be as short as the five minutes for which the SEATS screen goes into “adjust mode” in respect of the stock which is the subject of the announcement?

It will be difficult to give any definitive advice on these issues until there are court decisions or ASC rulings.

When does information come into a person’s possession?

A body corporate is taken to possess information if it comes into the possession of an officer in the course of the performance of his or her duties as an officer: s.1002E(a). Further, if an officer knows or ought reasonably to know any matter or thing because he or she is an officer of a body corporate, then it will be presumed that the body corporate knows or ought reasonably to know that matter or thing: s.1002E(b).

A partner in a partnership is taken to possess information if it comes into the possession of a fellow partner in his or her capacity as partner, or an employee of the partnership in the course of the performance of his or her duties as employee: s.1002F(a). In addition, if a partner or an employee knows or ought reasonably to know any matter or thing by reason of his or her position as partner or employee, then it will be presumed that all partners know or ought reasonably to know that matter or thing: s.1002F(b).

Chinese walls

The new insider trading provisions re-enact the exception provided in the former law for bodies corporate that maintained appropriate Chinese wall arrangements, and extend the exception to cover partnerships.

A body corporate or partnership is not precluded from entering into a transaction at any time merely because of information in the possession of an officer (in the case of a body corporate) or a partner or employee (in the case of a partnership) if:

(a) the decision to enter into the transaction was taken on its behalf by a person other than the officer,
partner or employee;

(b) it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to that person (ie, the person who took the decision) and that no advice with respect to the transaction was given to that person by a person in possession of the information; and

c) the information was not so communicated and no such advice was so given: ss.1002M and 1002N(1).

The inclusion of the word “reasonably” in paragraph (b) above is a slight relaxing of the former law under which Chinese walls were expressed as arrangements “to ensure” inside information was not communicated nor advice given.

Dealings on behalf of clients by licensed dealers

The new insider trading provisions re-enact the exception contained in the former law for dealings by licensed dealers on behalf of clients, but extend it to cater for the existence of Chinese walls.

Under the new provisions, a person (the agent) does not breach s.1002G(2) by subscribing for, purchasing or selling, or entering into an agreement to subscribe for, purchase or sell listed securities, even if the agent has inside information, if:

- the agent is the holder, or a representative of a holder, of a dealer’s licence;
- the agent entered into the transaction or agreement on behalf of a client under specific instructions;
- the holder of the dealer’s licence had in operation at the time arrangements that could reasonably be expected to ensure that any inside information in the possession of the holder or any representative of the holder was not communicated to the agent and that no advice with respect to the transaction or agreement was given to the client or the agent for a person in possession of the information;
- the information was not so communicated and no such advice was so given; and
- the client was not an “associate” of the holder or any representative of the holder: s.1002S.

The exception applies only if the transaction or agreement was entered into under specific instructions, not on discretionary account.

Brokers and fund managers who handle discretionary funds therefore cannot rely on s.1002S and, if they come into possession of inside information, must fall back on the more general Chinese walls provisions in ss.1002M and 1002N(1) referred to above. However there is some doubt whether they can so do, since it is not clear whether these two sections apply to acts done as agent for a client or whether they are limited to transactions or agreements entered into by a body corporate or partnership as principal in its own right.

The last requirement in s. 1002S that the client not be an “associate” creates real problems for an investment bank or a stockbroker which (as is often the case) is structured as a holding company with separate subsidiaries running its stockbroking and funds management arms. Typically, the funds-management subsidiary will use the broking subsidiary as its principal broker and there will be Chinese walls in operation between those subsidiaries.

In such a situation, the funds management subsidiary and the broking subsidiary are “associates” by virtue of being related bodies corporate and this precludes the broking subsidiary from relying on s.1002S in relation to orders from the funds-management subsidiary. If the broking subsidiary tells the funds-management subsidiary that it cannot take an order in relation to particular securities, the funds management subsidiary will almost certainly surmise why that is so. The effect is to lead to a breakdown of the Chinese walls because the funds management subsidiary will then know that the broking subsidiary is in possession of inside information.

What makes an effective Chinese wall?

There are no guidelines in the new insider trading laws on what arrangements will satisfy the legislative formulation for Chinese walls (arrangements “reasonably expected to ensure” that inside information is not communicated nor advice given). Some guidance can be found in ASX Business Rule 3.5 and in the AMBA Code of Conduct. While these do not determine what are “reasonable” Chinese wall arrangements for the purposes of the new insider trading provisions, a court is likely to treat them as being of persuasive authority.

Other exceptions

Specific exceptions are included in the new insider trading provisions to permit:

- redemption of prescribed interests under a buy-back covenant in a trust deed: s.1002I;
- underwriting and sub-underwriting transactions: s.1002J;
- a purchase pursuant to a requirement imposed by the Corporations Law, for example, under the compulsory acquisition procedures applicable under the takeover provisions: s.1002K;
- communication of information pursuant to a legal requirement, for example, information disclosed under a court order for discovery: s.1002K.

acquisitions of securities by or on behalf of a person who has inside information regarding proposed agreements or transactions to be entered into, or previous agreements or transactions entered into, by that person in relation to those securities: ss.1002P, 1002Q and 1002R.

This exception is designed to allow a person who intends to make a takeover offer for a company to acquire shares in the target even though the person has inside information about his or her own intentions.

Consequences of breaching the insider trading provisions

A person who breaches the new insider trading provisions:

- commits an offence which is punishable, in the case of an individual, by a $200,000 fine, five years’ jail or both, and, in the case of a body corporate, by a $1,000,000 fine; these penalties are substantially higher than under the former law;
- is liable to compensate the other party to the transaction (an issuer, seller or buyer) for any loss suffered because of the difference between the dealt price and the price that would have prevailed if the inside information had been generally available: ss.1013(2), (3) and (4);
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- can be sued by the body corporate whose securities were dealt in to recover the profit made by the insider on the dealing (profit again being measured by the difference between the dealt price and the price that would have prevailed if the inside information had been generally available) and the ASC can bring an action on behalf of the body corporate to recover such profit where it is in the public interest to do so: ss.1013(5) and (6);  
- is liable to compensate any person who has suffered any other loss or damage because of the breach: s.1005;  
- may be the subject of a wide range of remedial orders similar to those that can be made in respect of breaches of the takeover laws, for example, orders freezing voting and dividend rights or vesting securities in the ASC: s.1002U;  
- may be the subject of an injunction to prevent or require him or her from doing any act, matter or thing: s.1324; and  
- may be ordered to disclose information or to publish an advertisement: s.1004.

Further consequences include  
- if an insider improperly uses inside information acquired as an officer of a corporation to gain an advantage for himself or a third party, the insider breaches s.232(5), and is punishable by a $20,000 fine, five years' jail or both; and is liable to an action by the corporation to recover the profit made (ie, the insider can be sued by his or her employer);  
- if the insider is an agent or adviser and receives the inside information from, or in the course of acting for, his or her client and uses the inside information to make a personal profit without the informed consent of the client, he or she may be guilty of a breach of fiduciary duty, entitling the client to recover any profit made (ie, the insider can be sued by his or her client);  
- if the insider holds a dealer's licence or investment adviser's licence, the licence may be revoked or suspended: s.826/827/1002U(j);  
- the insider will automatically be subject to a five-year ban on being involved in the management of a corporation (which includes acting as a director) without the leave of the court if convicted of an offence under ss.1002G or 232(5): s.229(3).

Who can be prosecuted or sued?

Under the Corporations Law a criminal prosecution for breaching s.1002G may be brought against the insider. The Corporations Act 1989 deems an offence against any provisions of the Corporations Law (including s.1002G) in any state to be an offence against the laws of the commonwealth (to the extent that the constitution permits this). Under the Commonwealth Crimes Act 1914, any person who aids, abets, counsels or procures, or is in any way knowingly concerned in the commission of any offence against any commonwealth law is deemed to have committed the offence.

Consequently, in certain circumstances, a person who is involved or concerned in a contravention of s.1002G could also be the subject of a criminal prosecution under the Crimes Act.

A civil action under s.1013 may be brought against the insider; a person whom the insider procured to subscribe for, purchase or sell the relevant securities or to agree to subscribe for, purchase or sell the relevant securities; and any other person “involved” in the contravention. A person is “involved” in a contravention if he or she aids, abets, counsels, induces or procures; is knowingly concerned in or party to; or conspires with others to effect the contravention: s.79.

Defences

It is a defence to a prosecution in respect of an insider trading transaction (s.1002G(2)) or communication of inside information (s.1002G(3)) if the court is satisfied that:

(a) the information came into the possession of the insider solely as a result of the information being made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities of the relevant kind; or  
(b) the other party to the transaction or the recipient of the information knew, or ought reasonably to have known, of the inside information before entering into the transaction or before the information was communicated.

It is a defence to a civil recovery action under s.1013 if (a) above applies. There is no defence to a civil recovery action equivalent to (b) above but a person can bring such an action only if he or she was not aware of the inside information at the time of entering into the relevant transaction or agreement.

The defence in (a) above is intended to protect persons who receive information in the course of it being made known to the wider investment community and who innocently trade before a reasonable period of time has elapsed when the information, by definition, is not generally available. It does not protect a person who has received the information in any other way, for example, because he or she has advance warning of the information before it is publicly released.

Curiously, the defence in (a) above to a civil recovery action under s.1013 would seem to be available only to the insider and not to any person whom the insider procured to enter into a transaction or agreement in breach of the insider trading provisions, or to any other person involved in the contravention (both of whom can be sued under ss.1013(2)-(5)).

Conclusion

The ASC and its predecessor, the NCSC, did not record a single successful insider trading prosecution under the former law. It is to be hoped that the new insider trading provisions do prove to be more workable than the former law. If they are not, the Attorney-General has warned that the government will consider reversing the onus of proof so that persons accused of insider trading will be presumed to be guilty unless they can prove their innocence.