THE REFORM OF INSIDER TRADING LAW IN AUSTRALIA

ASHLEY BLACK*

I. INTRODUCTION

Insider trading may be characterised as trading by a trader who possesses information that is "material" to the price of the securities which are traded, which is not already known to other traders in the market.[1] A trader may obtain access to information of that nature as a result of his or her relationship with the issuer of the securities or with a prospective bidder for those securities; or as a result of a professional relationship with the issuer or a bidder of the securities; or by receiving the information from a person who has such a relationship.[2] The opportunity to undertake insider trading will be available to a person who has access to material information so long as the information has not been announced to the market: whether because the information is not yet sufficiently certain to be the subject of an announcement; or because the information cannot be released prior to completion of a transaction for reasons of commercial sensitivity or confidentiality. The issue of whether information is known to others in the market gives force to the characterisation of insider trading as

* Solicitor, Mallesons Stephen Jaques, Sydney.

1 MP Dooley "Enforcement of Insider Trading Restrictions" (1960) 66 *Virginia L Rev* 1 at 3; P Ryan "The Current Australian Position" in *Securities Law Seminar: Insider Trading* Faculty of Law Monash University (1985) p 3; AJ Black "Policies in the Regulation of Insider Trading and the Scope of Section 128 of the Securities Industry Code" (1988) 16 *MULR* 663 at 634.

2 WJ Carney "Signalling and Causation in Insider Trading" (1987) 36 *Catholic UL Rev* 863 at 863.

"essentially a problem of non-disclosure", originating in the access of the "insider" to information which indicates a disparity between the value (or the future market price) of securities and their present market price.[3]

Insider trading has been prohibited in Australia at least since the introduction of s 75A of the *Securities Industry Act* 1970 (NSW), which imposed criminal and civil liability for trading by a person associated with a corporation, for the purpose of obtaining a financial advantage, if that person possessed specific price-sensitive information relating to the corporation which was not generally known. That prohibition was extended in s 112 of the *Securities Industry Act* 1976 (NSW) and equivalent provisions in Queensland, Victorian and Western Australia. The latter provision was in turn continued in s 128 of the *Securities Industry Act* 1980 and in s 1002 of the *Corporations Law* 1990. Nonetheless, the significant amendments to the insider trading provisions, pursuant to the *Corporations Legislation Amendment Act* 1991, were enacted in the context of increased public and legislative attention to the regulation of insider trading in Australia. In part, that interest results from hearings conducted in 1989 by the House of Representatives Standing Committee on Legal and Constitutional Affairs (Griffiths Committee), which culminated in the publication of the Committee's Report in October 1989.[4] That interest also reflects publicity given to recent insider trading prosecutions in the United States, including the prosecutions of Boesky, Levine, and most recently Michael Milken.

II. RESEARCH AS TO THE EXTENT OF INSIDER TRADING IN AUSTRALIA

The recent interest in the scope of insider trading regulation may also reflect the considerable industry of Professor Tomasic and Mr Pentony in publishing[5] and in publicising[6] their researches into the extent of insider trading in Australia. That research has been described by Professor Tomasic as involving:

---

3 P Anisman *Insider Trading Legislation for Australia: An Outline of the Issues and Alternative* (1986) p 2.

4 *Fair Shares for All: Insider Trading in Australia* (October 1989).

5 The publications of Professor Tomasic and Mr Pentony in this field include: R Tomasic and B Pentony "Insider Trading Regulation and Law Enforcement in Australia", paper presented at Australian Universities Law Schools Association (August 1988); R Tomasic and B Pentony "Crime and Opportunity in the Securities Markets: The Case of Insider Trading in Australia" (1989) 7 *Co & Sec LJ* 186; R Tomasic "The Prosecution of Insider Trading: Obstacles to Enforcement" (1989) 22 *Aust & NZ J of Criminology* 65; R Tomasic and B Pentony "The Extent of Insider Trading in Australia: A Socio-Legal Account" (1990) 23 *Aust & NZ J of Criminology* 125; R Tomasic "Insider Trading Law Reform in Australia" (1991) 9 *Co & Sec LJ* 12; and R Tomasic (with the collaboration of B Pentony) *Casino Capitalism? Insider Trading in Australia* (1991).

6 It is perhaps not surprising that academic activity is no longer immune from the influence of public relations techniques. See the section headed "Methodology" in R Tomasic *Casino Capitalism, ibid* p 145, which refers (inter alia) to a practice of granting "exclusive rights to publish each report on project findings.... to a financial journalist from one newspaper", which it is said were followed by "reports in

> ...what for many lawyers would be seen as an unusual approach, an empirical study of the attitudes and experiences of key players in the securities industry with a view to systematically collecting more reliable evidence than the impressionistic material that has previously served as the basis for policy debates on insider trading in Australia.[7]

The method adopted in that research was for Professor Tomasic and Mr Pentony to interview brokers, lawyers employed by large firms, merchant bankers, financial journalists and officers of the National Companies and Securities Commission ("NCSC"), Corporate Affairs Commissions ("CACs") and Australian Stock Exchange ("ASX"). On the basis of those interviews, Tomasic and Pentony concluded that the precise extent of insider trading could not be quantified; that the level of insider trading was probably slightly lower than in the period prior to its prohibition by legislation, although (somewhat inconsistently) "the main difference is that it now seems to be less blatant"; that it was relatively easy to undertake insider trading using a false name, a nominee, or an off-shore vehicle; that there was a surprising "level of ignorance, especially among brokers, as to what constitutes insider trading"; that insider trading occurred predominantly, but not exclusively, in lower level stocks; and that insider trading was more likely to be undertaken by persons associated with the relevant company, although this "does not mean that others more actively engaged in the market do not do it".[8]

Tomasic and Pentony found that insider trading generally took place in the market for shares rather than for options;[9] was frequently related to takeover activity; that "one of the most blatant opportunities for insider trading arises from the readiness of companies to selectively divulge price sensitive information about their corporation to brokers, institutions and large shareholders"; and that house trading by brokers "occurs not infrequently before clients are informed of price sensitive information or advised to trade in the particular stock."[10] Tomasic and Pentony assert that the self-regulatory organisations "are poor means for regulation of insider trading", since they are said to be "primarily concerned with protecting the level of market activity by their members rather than being concerned with driving deviant members out of the securities industry", while "[t]his preoccupation leaves little room for concern about the small investor."[11] They conclude that the CACs were unduly reluctant to undertake prosecutions for insider trading; that the lack of

---

other newspapers, magazines, radio and television which then provided further coverage of findings from the study."

7 R Tomasic *Casino Capitalism* note 5 *supra* p 1.

8 *Ibid* p 51-54.

9 *Ibid* p 69.

10 *Ibid* pp 75, 77, 87.

11 R Tomasic and B Pentony "The Prosecution of Insider Trading" note 5 *supra* at 65. This assertion is surprising, given the practice of the ASX of regularly referring suspicious market activity to the Australian Securities Commission ("ASC") for investigation; and the fact that the self interest of members of the ASX may well require that it excludes "deviant members" from the industry so as to preserve investor confidence and thereby to "protect ... the level of market activity by [its] members."

prosecutions reflected "the failure of the industry itself, and especially of the self regulatory bodies such as the Australian Stock Exchange, to be sufficiently vigorous in their support of the prosecution effort"; and that both the CACs and ASX "have been poorly resourced and inadequately staffed and equipped to deal with complex crimes such as insider trading."[12]

Tomasic and Pentony argue that insider trading reflects the values of and the social organisation of the securities industry. Indeed, they assert that "[p]eer group pressure to conform to what can be described as the culture of greed and a prevailing 'casino mentality', as well as tolerance of share market manipulation, have become ingrained within the social structure of the industry."[13] In apparent contradiction to that assertion, they also found that the overwhelming view of participants in their survey was that insider trading was harmful and that the repeal of insider trading legislation would affect market confidence.[14]

Tomasic and Pentony suggest that the securities laws have "increasingly been come to be seen as a largely symbolic mechanism and, at best, a weak vehicle for orderly marketing."[15] Tomasic argues that "Australian courts have failed to take a commercially realistic approach [to insider trading] and have readily succumbed to the safe harbour of legalism..... the relevant legislation has virtually made narrow legalistic readings of this body of legislation inevitable."[16] Although Tomasic and Pentony had found that the extent of insider trading in Australia could not be quantified, and indeed that insider trading was either less common or alternatively less blatant than previously, they nonetheless concluded that:

> insider trading in Australia has reached a point where the current corporate and securities laws have reached their limits in being able to control the social and economic problem of insider trading.[17]

The NCSC Submission to the Griffiths Committee noted that the conclusions reached by Tomasic and Pentony confirmed popular belief as to the extent of insider trading in Australia, "[n]otwithstanding queries that could be raised about the research methodology."[18] Professor Tomasic has noted that one stock exchange official "sought to dismiss the findings [of his study] as being anecdotal", and further that "some economically oriented commentators were critical of the lack of statistical information from [his] study". He responds that such criticisms are "largely based upon a failure to appreciate the need to adopt

12 R Tomasic *Casino Capitalism* note 5 *supra* p 126.

13 R Tomasic and B Pentony "The Prosecution of Insider Trading" note 5 *supra* at 65.

14 R Tomasic *Casino Capitalism* note 5 *supra* pp 55, 60-61, 67.

15 R Tomasic and B Pentony "The Prosecution of Insider Trading" note 5 *supra* at 65.

16 R Tomasic *Casino Capitalism* note 5 *supra* p 142. This passage is notable for its use of the vague but apparently perjorative terms "legalism" and "narrow legalistic", by contrast with the vague but apparently eulogistic phrase "commercially realistic". One might venture the general observation that references to "commercial realism", which may well assist in commercial decision-making, are rarely illuminating in the analysis of legal or public policy issues.

17 *Ibid* p 54.

18 NCSC Submission to the Griffiths Committee; s 110.

research methods appropriate to the phenomenon under scrutiny."[19] It might be suggested that the survey method adopted by Tomasic and Pentony provides empirical evidence of the beliefs and opinions of the brokers, lawyers and regulators who were interviewed (which may or may not be well-founded) and not of the fact. The difficulty with that method can be illustrated by considering its application to an investigation of the extent of witchcraft in New England in the seventeenth century. If one were to have conducted contemporaneous interviews with a small sample of householders, clergymen and lawyers in Salem, Massachusetts, one would have concluded that the extent of witchcraft was difficult to determine precisely, but that witchcraft was certainly widespread. One might have gone further, to suggest that the legal system had reached its limits in being able to control the social and economic problem of witchcraft. The historical evidence is, of course, to the contrary.[20] This objection to the use of a survey of beliefs and opinions to provide evidence of the underlying fact is not answered by saying that witchcraft (or insider trading) is a hidden crime; that witches (or insider traders) are difficult to identify; that witchcraft (or insider trading) is not readily susceptible of other forms of empirical analysis; or that one must adopt research methods appropriate to the phenomenon under scrutiny.

III. POLICY JUSTIFICATIONS FOR THE REGULATION OF INSIDER TRADING

Recent amendments to insider trading law should be assessed by reference to the objectives which the regulation of insider trading is intended to achieve: thus, the Griffiths Committee observed that "[i]n determining the adequacy of the legislative and administrative controls over insider trading, it is first necessary to consider the rationale for having such controls."[21] There is a substantial body of American academic literature dealing with the policies underlying the regulation of insider trading, assessed in the light of the experience of regulation of insider dealing under Rule 10b-5 made under the

---

19 R Tomasic *Casino Capitalism* note 5 *supra* p 145.

20 JP Demos *Entertaining Satan: Witchcraft and the Culture of Early New England* (1982).

21 Note 4 *supra* p 13.

Securities Exchange Act 1934 (US).[22] There are a number of Australian articles in the same area of discourse.[23]

The Griffiths Committee noted that various justifications have been offered to support the prohibition on insider trading: including that of fairness, based on the proposition that market participants should have equal access to information from an issuer of securities; that of fiduciary duty, based on the proposition that a person who holds a position of trust should not make a personal profit from that position without the informed consent of his or her beneficiaries; that of economic efficiency, which suggests that insider trading is damaging to the efficient operation of the financial market; and that of corporate injury, based on the proposition that insider trading injures the company which issued the securities, the shareholders in the company and investors who deal with insiders.[24]

The Griffiths Committee noted the view of Professor Manne that insider trading moved the price of securities towards the real value of the securities, bringing about a better informed and more efficient market, and that insider trading allowed entrepreneurs to receive financial rewards for innovation.[25] It has been argued by some commentators that the provision of information by this means reduces search costs for all participants in the market, and that insider trading is therefore tolerated in the market because its costs to the issuer of securities are less than its benefits. Although these arguments have received some support from Australian commentators,[26] they are open to several criticisms. Insider trading is likely be slower in affecting market prices and less accurate as an indicator of underlying value than direct disclosure of information by the issuer. Trading by a single trader is unlikely to significantly affect the price of securities, so as to cause that price to reflect inside information to which that trader has access, unless other traders can identify that trader as a person who has access to inside information.[27] The suggestion that insider trading provides a desirable incentive for corporate officers is also flawed, since a person who benefits from trading on inside information is not necessarily the person responsible for innovation; insider trading does not

22 To single out a number of useful commentaries from a wealth of possibilities, see V Brudney "Insiders, Outsiders and Informational Advantages under the Federal Securities Laws" (1979) 93 *Harv L Rev* 322; WKS Wang "Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Under SEC Rule 10b-5" (1981) 54 *Southern California L Rev* 1217; DW Carlton and DR Fischel "The Regulation of Insider Trading" (1983) 35 *Stan L Rev* 857; and DC Langevoort *Insider Trading Regulation* (1991 ed). This literature is described by Professor Tomasic as "that abstract and sterile debate concerning the policy issues surrounding the enforcement of insider trading which has particularly characterised the North American law review literature": R Tomasic *Casino Capitalism* note 5 *supra* p 1.

23 KJ Skoyles "The Fiduciary Basis of Insider Trading Liability: Dirks Down Under?" (1984) *Co & Sec LJ* 13; AJ Black note 1 *supra*; JD Cox "An Outsider's Perspective of Insider Trading Regulation in Australia" (1990) 12 *Syd L Rev* 454.

24 Note 4 *supra* p 13.

25 *Id*; H Manne *Insider Trading and the Stock Market* (1966).

26 W Hogan "Insider Trading" (1988) 6 *Co & Sec LJ* 633.

27 DC Langevoort "Investment Analysts and the Law of Insider Trading" (1990) *Virginia L Rev* 1023.

necessarily reward that person in proportion to the value of any innovation; and insider trading allows insiders to profit from trading in anticipation of corporate failures as well as corporate successes. Moreover, the possibility of earning profits from insider trading may encourage corporate insiders to withhold information from the market so as to serve the insider's trading interests. The result would be that the market is misinformed and, to the extent of that misinformation, inefficient.[28] The Griffiths Committee rejected Manne's arguments, on the ground that they "ignore the practical reality that insider trading damages an essential component in the proper functioning of the securities markets, that is investor confidence."[29]

The Griffiths Committee echoed the view of the Committee of Inquiry into the Australian Financial System (Campbell Committee) that:

> The objective of restrictions on insider trading is to ensure that the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends importantly on the prevention of the improper use of confidential information.[30]

On this view, the prevention of fraud and the promotion of disclosure are necessary for the maintenance of an efficient market.[31] Arguably, if insider trading results in a loss of confidence in the integrity of the securities market, investors will either look to other investment avenues or will demand higher risk premiums, increasing the cost of capital to companies.[32] The prohibition of insider trading may also be supported as a means of reducing the costs involved in individual investors seeking to police market transactions in which they are involved, so as to avoid being disadvantaged against a trader with access to inside information.[33] Finally, it might be suggested that legislation prohibits insider trading on the grounds of the intrinsic desirability of a minimum standard of "fairness" in the securities market.[34]

---

28 P Anisman note 3 *supra* p 8; S Levmore "Securities and Secrets: Insider Trading and the Law of Contracts" (1982) 68 *Virginia L Rev* 117 at 150-151; AJ Black note 1 *supra* at 635-636.

29 Note 4 *supra* p 17.

30 Final Report of the Committee of Inquiry into the *Australian Financial System* (1981) p 382, cited in *Fair Shares for All* note 4 *supra* p 17.

31 Note 3 *supra* at 6; AJ Black note 1 *supra* at 637.

32 L Loss "The Fiduciary Concept as applied to Corporate Insiders in the United States" (1970) 33 *Mod L Rev* 34 at 36; V Brudney note 22 *supra* at 335; AJ Black note *supra* at 636-637. This argument is open to the criticisms that it is difficult to identify measurable harm to particular investors from the existence of insider trading in a public market; and that the possibility of insider trading is one of a number of hazards of investment which are reflected in the price at which securities are traded: DC Langevoort note 27 *supra* at 1048.

33 V Brudney note 22 *supra* at 356; S Levmore note 28 *supra* at 121.

34 V Brudney note 22 *supra* at 334; AJ Black note 1 *supra* at 637.

IV. THE ACCESS TO INFORMATION AND THE FIDUCIARY PRINCIPLES

American authorities as to the application of Rule 10b-5,[35] made under the *Securities Exchange Act* 1934 (US), have articulated two groups of principles which might provide the basis for delimiting the scope of the prohibition on insider trading.[36] These principles look respectively to the fiduciary status of the insider and to his or her possession of informational advantages. In *Cady Roberts & Co*,[37] an employee of a broking firm was also a director of a publicly held company and learned of a proposed reduction in dividends paid by the company in his capacity as a director. He revealed that information to a partner in the broking firm, who sold shares in the company on account of several clients of the broking firm prior to the public announcement of the dividend reduction. The Securities and Exchange Commission (US) took the view that the prohibition on insider trading was partly founded on fiduciary principles, since a relationship between an insider and a company gave access to information which could be used only for corporate purposes and "not for the personal benefit of anyone". At the same time, the SEC relied on the "inherent unfairness" of the insider trading with information "knowing that it is unavailable to those with whom he is dealing".[38]

The access to information approach suggests that investors in a market should have an equal opportunity to obtain and evaluate information relevant to trading decisions. In *SEC v Texas Gulf Sulphur Company*,[39] the directors and officers of a mining company were held liable for profits made as a result of trading on undisclosed information as to a discovery of mineral deposits. The Court emphasised the access to information principle, holding that the trading by company directors and officers who possessed material nonpublic information was contrary to the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to information."[40] The emphasis upon inequality of information was again evident in *Shapiro v Merrill Lynch, Pierce, Fenner & Smith Inc*,[41] where the court observed that the intention of Rule 10b-5 was to secure "fair

35 Rule 10b-5 provides that it is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate trade or commerce, or of the mails, or of any facility of any national securities exchange, to employ any device, scheme or artifice to defraud; to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances, not misleading; or to engage in any act, practice or course of business which operates or would operate as fraud or deceit upon any person; in connection with the purchase or sale of any security.

36 P Anisman note 3 *supra* p 11; AJ Black note 1 *supra* at 638-639.

37 40 SEC 907 (1961).

38 *Ibid* 912.

39 401 F 2d 833 (1968), cert denied 394 US 976 (1969); KJ Skoyles note 23 *supra* at 14; AJ Black note 1 *supra* at 638: JD Cox note 23 *supra* at 463.

40 *Id*.

41 495 F 2d 228 (2d Cir 1974) at 235.

dealings in the securities markets" and to "prevent corporate insiders and their tippees from taking unfair advantage of.... uninformed outsiders." The access to information approach has received some academic support. It has been argued that the insider trading prohibition should be directed to preventing insiders trading on the basis of information obtained by the insider from a nonpublic source, since that information allows the insider an information advantage which cannot be overcome by lawful research efforts of other investors.[42] The emphasis, in this version of the access to information theory, on the fact that an information advantage is "unerodable" recognises that a trader may properly obtain an information advantage as a result of research efforts or analysis, if the same advantage could be obtained by other traders with equal diligence and resources.

However, in *US v Chiarella*,[43] the US Supreme Court rejected the argument that Rule 10b-5 was breached simply by trading with an unerodable information advantage over others.[44] In that case, an employee of a printing firm traded using information as to impending takeovers which he had obtained in the course of printing the tender documents. The majority held that, in the absence of a breach of a "relationship of trust and confidence" owed to those with whom he traded, the employee had not contravened Rule 10b-5.[45] This reasoning was followed in *Dirks v SEC*,[46] the facts of which are discussed below. These decisions suggested that the prohibition on insider trading was restricted to persons who were subject to an existing fiduciary duty, arising from a prior relationship between the insider and either the issuer of the securities or the other party to the trade. This class of persons would include officers of the company; outsiders with a special relationship to the company, such as its legal advisers, accountants and financial advisers; and persons who obtained material nonpublic information from persons who owed a fiduciary obligation to the company.[47]

In *Chiarella*,[48] the US Supreme Court left open the possibility that Rule 10b-5 would be contravened if an insider traded on information which he or she had "misappropriated" from another, even if the insider was not under a fiduciary obligation either to the issuer of the securities or to the other party to the trade; although the majority held that the misappropriation theory was not available to found a conviction in that case since it had not been put to the jury

42 V Brudney note 22 *supra* at 354; J Suter *The Regulation of Insider Trading in Britain* (1989) p 42.

43 445 US 222 (1980); see also DC Langevoort "Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement" (1982) 70 *California L Rev* 1; FH Easterbrook "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information" (1981) 11 *Supreme Court Review* 309 at 321.

44 445 US 222 (1980) at 233.

45 *Ibid* at 228-230, 233.

46 463 US 464 at 657-658.

47 GG Lynch and WE Morse (Division of Enforcement, US Securities and Exchange Commission), "Insider Trading and Market Manipulation in the International Arena: A Challenge to Territorial Enforcement" paper delivered at the Annual Conference of the International Organisation of Securities Commissions (November 1988) p 15.

48 Note 43 *supra*.

at trial.[49] American immediate appeal courts have subsequently adopted the misappropriation approach, holding that Rule 10b-5 is contravened if the insider has breached a duty of confidentiality owed to his or her employer in taking advantage of information obtained in the course of employment by trading in securities.[50] The effect of the misappropriation theory is to prohibit trading by a person who is entrusted with nonpublic information by a person to whom he or she owes a fiduciary duty, or who is given information on the basis that he or she will hold it in confidence, regardless of whether the individual is a corporate insider or owes a duty to the other party to the transaction.[51] In *Carpenter v US*[52] the US Supreme Court divided evenly as to the validity of the misappropriation theory and therefore affirmed the judgment of the Second Circuit Court of Appeals which had held the defendants to be liable under that theory. The misappropriation theory seems to have arisen in large part as a product of the statutory regime established by Rule 10b-5 in the United States and of attempts by American intermediate appeal courts to avoid the narrowing of Rule 10b-5 which appeared to follow from the reasoning in *Chiarella*.[53] The insider's breach of an obligation of confidentiality owed to his or her employer seems in principle to be a less persuasive justification for prohibiting the insider from trading with third parties in an impersonal market than the insider's unerodable information advantage as against other participants in the market deriving from the breach.[54]

An access to information approach, a fiduciary approach and a misappropriation approach would not necessarily lead to the same conclusions as to the appropriate scope of the insider category. To the extent that the fiduciary approach is based on previous dealings of the parties to a transaction, it is not readily applicable to transactions between insiders and persons who are not already shareholders. Such transactions are the norm in the trading of securities in public securities markets, where other traders on the market are typically not beneficiaries of a fiduciary duty owed by an insider, either to the company or its shareholders.[55] An access to information approach requires an assessment of the insider's dealings with all persons trading in the market at a particular time.[56] It is therefore likely to support a wider prohibition on insider trading than a fiduciary approach.

---

49 *Ibid* at 236.

50 *US v Newman* 556 F 2d 12 (1981), cert denied 464 US 863 (1984); *SEC v Materia* 745 F 2d 197 (1984); *US v Carpenter* 791 F 2d 1024 (1986).

51 GG Lynch and WE Morse note 47 *supra* pp 640-641.

52 484 US 19 (1987).

53 SA Boinski "Securities Regulation - Newspaper Reporter's Trading on basis of Misappropriated Prepublication Information as Rule 10b-5 Violation" (1987) 60 *Temple Law Quarterly* 215 at 236.

54 AJ Black note 1 *supra* at 640-641.

55 BAK Rider *Insider Trading* (1983) pp 99-100, AJ Black note 1 *supra* at 645.

56 AJ Black note 1 *supra* at 637-638.

V. THE PRIMARY PROHIBITION ON INSIDER TRADING: S 1002G(2)

Section 1002G(1) of the Corporations Law has the effect that the primary prohibition applies where:

(a) a person (the 'insider') possesses information that is not generally available but, if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of securities of a body corporate; and

(b) the person knows, or ought reasonably to know, that:

   (i) the information was not generally available; and

   (ii) if it were generally available, it might have a material effect on the price or value of those securities.

In order to fall within the scope of s 1002G it is necessary that (1) a person possesses information that is not generally available; (2) a reasonable person would expect that information to have a material effect on the price or value of securities of a body corporate if the information was generally available; and (3) the person knows, or ought to know, that the information is not generally available and that, if it were generally available, it might have a material effect on the price or value of those securities. The term "securities" is defined in s 1002A(1), for the purposes of Part 7.11 Division 2A and s 1013, as shares in a body corporate; debentures, including convertible notes, issued by the body corporate; prescribed interests made available by the body corporate; units of shares in the body corporate or of prescribed interests made available by the body corporate; and option contracts under which a person acquires from another party an option or right, exerciseable at or before a specified time, to buy from, or sell to, that other party a number of securities in any of the other categories falling within that definition, at a price specified in or determined in accordance with the contract. The definition of "securities" in s 1002A extends the effect of Part 7.11 Division 2A to apply to trading in tradeable options over and rights to issued securities[57] and to trading in prescribed interests. The terms "purchase" and "sell" are in turn given an extended meaning in s 1002A, so as to include the closing out of exchange-traded options. The definition of "securities" in s 1002A expressly excludes futures contracts and excluded securities, as defined in s 9 of the *Corporations Law*.

A body corporate is treated as possessing any information which an officer of the body corporate possesses and which came into his or her possession in the course of performance of his or her duties as an officer: s 1002E(a). A body corporate is also treated as though it knows, or ought reasonably to know, any information which an officer of the body corporate knows or ought reasonably to know because he or she is an officer of the body corporate: s 1002E(b).

57 It has been noted that this definition may not extend to options or rights to subscribe for unissued securities, since a person subscribes for (rather than buys) unissued securities and an issuer does not sell such securities: Butterworths *Australian Corporation Law* at [7.4.0075].

Section 1002E(b) has the effect that, if the officer who obtained the relevant information knew or ought reasonably to have known that the information was not generally available and that it might have a material effect on the price or value of the securities if it were generally available, it is presumed that the body corporate knew or ought reasonably to have known those matters. Section 1002M allows a defence to a body corporate which maintains a chinese wall, the effect of which is discussed below. Sections 1002Q and 1002R (which correspond to the former s 1002(8)) preserve the ability of a body corporate to deal in securities of another body corporate, for example by way of on-market purchases of shares in the other body corporate, when previous or proposed dealings by the body corporate in securities of the other body corporate are not public knowledge. This exemption would apply, for example, if a body corporate purchased shares in another body corporate in anticipation of making a takeover offer or announcement.

A member of a partnership is treated as possessing any information which another member of the partnership possesses and which came into his or her possession in the other member's capacity as partner; or which an employee of the partnership possesses and which came into his or her possession in the course of performance of his or her duties as an employee of the partnership. Every member of the partnership is treated as though he or she knows, or ought reasonably to know, any information which a member or employee of the partnership knows or ought reasonably to know because he or she is such a member or employee: s 1002F. A partnership which maintains a chinese wall also has a defence to a contravention of s 1002G: s 1002N(1). An exemption is also available to transactions undertaken by a partner in his or her own interest, and not for the benefit of the partnership: s 1002N(2).

VI. CONNECTION WITH A BODY CORPORATE

Prior to the amendments made by the *Corporations Legislation Amendment Act* 1991, the prohibition on insider trading applied to persons who were connected with a body corporate: s 1002(1). Section 1002(9) specified certain circumstances in which a person would be connected with a body corporate, with the effect that a person was so connected if he or she was an officer of the body corporate or a related body corporate; a substantial shareholder in the body corporate or a related body corporate for the purposes of Part 6.7 of the *Corporations Law*; or was within a business or professional relationship with the body corporate or a related body corporate; or was an officer of a substantial shareholder in the company or a related company. The application of the prohibition on insider trading to officers of the company could be supported on a fiduciary basis, since insider trading is inconsistent with the duty of loyalty owed to a company by its officers. There are also functional justifications for the application of insider trading prohibitions to company directors and officers

and substantial shareholders. A substantial shareholder is likely to be able to obtain information about the company which is not available to minority shareholders or to the market. Since insiders are given access to company information "at the expense of the enterprise, and for the purpose of conducting the business for the collective good of all stockholders", then "[t]here is no reason for them to be entitled to trade for their own benefit on the basis of such information".[58]

The Griffiths Committee suggested that it was "the use of information, rather than the connection between a person and a corporation, which should be the basis for determining whether insider trading has occurred".[59] Section 1002G(1), as amended, does not require that there exist any connection or relationship between a person who is prohibited from trading and the body corporate which is the issuer of the securities. A person becomes an "insider" for the purposes of s 1002G simply by possessing information having the relevant quality, if that person knows or ought reasonably to know that the information is not generally available and that it might have a material effect on the price of the securities, if it were generally available.[60] The removal of the connection requirement has the effect that s 1002G adopts an "access to information" approach to the regulation of insider trading.

In some instances, the removal of the connection requirement has no effect since a connection would have existed for the purposes of the former s 1002(9). Consider, for example, the facts of *US v Chiarella*,[61] which were noted above. A printer traded on information as to impending takeovers which he had obtained in the course of printing the takeover documents. Under s 1002(9), a person connected with a body corporate for the purposes of the prohibition on trading under s 1002(1) and s 1002(2) included a person who occupied a position which would be reasonably expected to give access to material price-sensitive information by virtue of a business relationship between his or her employer and the body corporate. This provision would have been sufficiently wide to catch a person in the position of Chiarella. That person will also be caught under s 1002G if the relevant information is not generally available, and a reasonable person would have expected it to have a material price on the effect of securities when it became generally available; and if that person knows or ought reasonably to know that the information is not generally available and that it might have a material effect on the price of the securities, if it were generally available. In these circumstances, the removal of the connection requirement in s 1002G has no effect.

However, consider the facts of *Carpenter v US*.[62] Winans, who was a columnist for the *Wall Street Journal*, passed information about the contents

---

58 V Brudney note 22 *supra* at 343-4; AJ Black note 1 *supra* at 642.

59 Note 4 *supra* p xv.

60 WJ Beerworth "New Insider Trading Legislation" (1990) *Butterworths Corporation Law Bulletin* [373].

61 Note 43 *supra*.

62 Note 51 *supra*.

and publication dates of his columns to two brokers employed by a New York broking firm. The brokers traded profitably by anticipating the likely market effect of information published in the columns, and had an arrangement to share the profits with Winans. Winans was under no prior fiduciary obligation either to the companies the shares of which were traded or to the other parties to the trades. The Second Circuit Court of Appeals held that both Winans and the brokers had violated Rule 10b-5 under the misappropriation theory, on the basis that Winans had misappropriated information from his employer in breach of a duty of confidence. The US Supreme Court was evenly split on the issue of liability under Rule 10b-5, but upheld a conviction for mail and wire fraud on the ground that Winans had misappropriated information which was the "property" of his employer.

Under the former s 1002(9), a person in the position of Winans would not have been connected with the issuers of the shares which were traded by the brokers, since he was not an officer of those companies or their related companies; was not a substantial shareholder in those companies or an officer of a substantial shareholder; and neither he nor his employer had a business or professional relationship with those companies. Accordingly, a person in the position of Winans would not have contravened s 1002(1) or s 1002(2) by trading on information as to the contents of his columns, nor would he have contravened s 1002(5) by communicating information to the brokers. The removal of the connection requirement in s 1002G reverses the result in this situation. A journalist in the position of Winans would be prohibited under s 1002G(2) from buying or selling or subscribing for securities if the relevant information (being the contents of his column) was not yet generally available, and a reasonable person would have expected the information contained in that column to have a material price on the effect of securities in a company when it became generally available; and if the journalist knew or ought reasonably to have known that the information was not generally available and that it might have a material effect on the price of the securities, if it were generally available. If trading in the securities of the relevant company was permitted on the stock market of a stock exchange, a journalist in the position of Winans would be prohibited under s 1002G(3) from communicating the contents of his or her column to the brokers, if the journalist knew or ought reasonably to know that the brokers would be likely to subscribe or purchase or sell the securities; or enter an agreement to do so; or procure a third person to do so.

VII. MATERIALITY OF INFORMATION

Since a person who possesses material nonpublic information may be prohibited from trading under s 1002G although he or she is not connected with the relevant body corporate, the questions whether information is material and whether it is publicly available are of increased importance. Earlier New South Wales cases took a relatively narrow view of the kind of information which might trigger the insider trading prohibition.[63] A wider view was taken in Victoria in *Corporate Affairs Commission v Green.*[64] That wider view was followed at first instance in *Hooker Investments Pty Limited v Baring Brothers Halkerston Securities Limited*,[65] where Young J held that information would include "factual knowledge of a concrete kind or that obtained by means of a hint or veiled suggestion from which one can impute other knowledge".[66] The term "information" is now widely defined in s 1002A(1) as including "matters of supposition and other matters that are insufficiently definite to warrant being made known to the public" and matters relating to the intentions and likely intentions of a person.

The Griffiths Committee recommended that the question whether information was material be answered by reference to whether "a reasonable person could expect it to have a material effect on the price or value of the securities issued by the company which is the subject of the information".[67] The Griffiths Committee supported its recommendation on the grounds that the Courts were familiar with the application of the "reasonable person" test, which was applied in other contexts; that the test was objective in nature; and that it removed the necessity for expert evidence. The Committee noted that such a test was already applied in American law, and that experience in the United States suggested that it was unlikely to give rise to major difficulties of interpretation. The Committee observed that consistency with the approach adopted in the United States was itself desirable in the light of the internationalisation of securities markets.[68]

Section 1002G applies where, inter alia, a reasonable person would expect nonpublic information to have a material effect on the price or value of securities of a body corporate if the information was generally available; and the person knows, or ought to know, that the information is not generally available and that, if it were generally available, it might have a material effect on the price or value of those securities. A reasonable person is to be taken to expect information to have such an effect if "the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell" such securities: s 1002C. The

63 *Ryan v Tirguboff* [1976] 1 NSWLR 588.

64 [1978] VR 505.

65 (1986) 10 ACLR 462 at 463.

66 *Ibid* at 467-468.

67 Note 4 *supra* at [4.4.17].

68 *Ibid* at [4.4.14]-[4.4.15].

fundamental issue under a test of this kind is the influence of information on investor decision-making.[69] It seems that information will be material, under that test, if it would impact on the investment decision-making of persons who commonly invest in securities, taken together with other information available in the market to such investors.[70]

One commentator has argued that the effect of s 1002C is to substitute the test of whether information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to deal in them, for the apparent test of whether a reasonable person would expect information to have a material effect on the price or value of securities of the company.[71] That view does not give sufficient weight to the connection between, on the one hand, the likelihood that information will have a material effect on the price or value of the securities; and, on the other, the effect of that information on trading decisions of investors who commonly invest in securities. The "semi-strong" form of the efficient market hypothesis suggests that prices of shares traded in the securities markets accurately reflect all publicly available information, as a result of the efforts of analysts to identify undervalued securities by analysis of available information and as a result of trading undertaken on the basis of such analysis.[72] Alterations in the price at which securities are traded on the market therefore reflect trading decisions of those who commonly invest in securities, made in response to additional information about those securities. The use in the test adopted in s 1002C (ie whether information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to deal in them) is therefore supportable as recognising the manner in which trading decisions of investors affect the market price of securities. Even in the absence of the deeming provision in s 1002C, a reasonable person would have expected information to have a material effect on the price or value of securities of a company, for the purposes of s 1002G, if that information would, or would be likely to, influence the trading decisions of persons who commonly invest in securities in deciding whether or not to deal in the securities.

It is at least arguable that, for the purposes of s 1002C, the class of persons who commonly invest in securities comprises largely institutional investors, licensed dealers and professional investors (in the sense of those who carry on a business of investing in the securities markets), who may be taken to act rationally in determining whether information is in fact sufficiently significant to impact on trading decisions. The emphasis in s 1002C on whether

69 H Heller "*Chiarella* SEC Rule 14e-3 and *Dirks* "Fairness versus Economic Theory" (1982) 37 *Business Lawyer* at 526-7.

70 For a similar analysis of the concept of materiality under American law, see DC Langevoort note 22 *supra* at 142.

71 Note 60 *supra* at [390].

72 CP Saari "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" (1977) 29 *Stan L Rev* 1031 at 1044, 1050; D Fischel "Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Trading Securities" (1982) 38 *Business L Rev* 1; Butterworths *Australian Corporation Law* at [7.1.0125].

information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to deal in them can be justified on the basis that trading by institutional and professional traders is a significant source of movements in the price at which securities are traded on-market.[73]

However, an area of difficulty arises if information is significant only in the light of its relationship with other information which is publicly available but not widely known. For example, assume that fact "A" would not affect the trading decisions of persons who commonly invest in securities in relation to a particular security, in the light of information generally known in the market, but would affect trading decisions of those persons if they had connected fact "A" with fact "B" which is known to a particular investor as a result of that investor's research into publicly available information. In those circumstances, the better view is that trading by the investor on the basis of fact "A" is not within the scope of s 1002G, since that fact alone would not influence the trading decisions of persons who commonly invest in securities. The result would differ if investment analysts and professional investors were generally aware of fact "B", and fact "A" would have affected their investment decisions in the light of that knowledge.

VIII. AMERICAN CASE LAW AS TO MATERIALITY

The express reference in the Report of the Griffiths Committee to the approach adopted by American courts suggests that the decisions of those Courts should provide persuasive authority as to the concept of materiality adopted in s 1002G. American courts have held that, for information to be "material", it must be information of a kind that would affect the decision of a reasonable investor as to whether to retain or to trade securities, and must have a relatively high probability of occurrence. For example, in *SEC v Texas Gulf Sulphur Company*,[74] the Court held that the results of drilling which indicated a strong possibility (although not a certainty) of a significant mineral discovery were material information. In *TSC Industries Inc v Northway Inc*,[75] the US Supreme Court held that information will be material:

> ...if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [how to exercise voting rights attached to its shares] ... Put another way, there must be a substantial likelihood that the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[76]

---

73 Cf DC Langevoort note 22 *supra* at 375, noting that "[u]nder the efficient market hypothesis, price movements are largely the product of institutional trading, directly and promptly caused by analyst recommendations. Consequently, large price movements can occur based on the disclosure of information that is immediately meaningful only to the highly sophisticated investment community."

74 Note 39 *supra*.

75 426 US 438, 439 (1976).

76 *Ibid* at 449.

At the same time, the Court noted that some information would be so uncertain that it should not be treated as material.[77]

In *SEC v Bausch & Lomb Inc*,[78] the *TSC Industries*[79] test was applied in determining the materiality of information in the context of insider trading. The Court there held that information as to the "flattening out" in sales of one product of a company and a delay in the introduction of two new products, which had been disclosed to an investment analyst, was not material for the purposes of Rule 10b-5; whereas information as to actual earnings of the company was material. In *Elkind v Liggett & Myers Inc*,[80] the Court held that a statement which confirmed the existing expectations of investment analysts as to a company's difficulties was not material, whereas a statement that earnings of the company had in fact decreased was material. In *Basic Inc v Levinson*,[81] the US Supreme Court held that the likelihood that a possible future event (for example, a merger) would occur should be balanced against the magnitude of its likely consequences in determining whether information as to that event was material. The Court concluded that, although the materiality of merger negotiations would depend on the particular facts, "[n]o particular event or factor short of closing the transaction need be either necessary or sufficient by itself to render merger discussions material."[82] In *Wilson v Great American Industries Inc*,[83] the Court noted that information relating to a future event could be material, if there was a sufficient likelihood that such an event would take place.

Section 1002G, read together with s 1002C, appears to remove the necessity for expert evidence as to the likely effect of particular information on the market price at which securities are traded. The question of whether information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell such securities will be a question for the Court.[84] In leading evidence as to that question, the prosecution may rely on an alteration in the market price of the securities following the announcement of the information to the market, since the efficient market hypothesis suggests that such an alteration may reflect trading decisions made by investors in response to that information. The American courts have accepted that such evidence may be rebutted by evidence that the alteration in the market price resulted from other factors, such as the release of other information or price movements in the market generally.[85] The

77 *Ibid* at 448.

78 565 F 2d 8 at 18 (2d Cir 1977).

79 Note 75 *supra*.

80 635 F 2d 156 at 167 (2d Cir 1980).

81 108 S Ct 978 (1988).

82 *Id* 987.

83 855 F 2d 987 (2d Cir 1988).

84 AJ Black note 1 *supra* at 651. The same conclusion was reached in the Submission of the Attorney-General's Department to the Griffiths Committee, s 541.

85 *Elkind v Liggett & Myers Inc* note 80 *supra* at 166; DC Langevoort note 22 *supra* at 152.

absence of an alteration in the market price after information is formally announced to the market is not conclusive, since the substance of the information may previously have become known by contacts with investment analysts or market rumours.[86] The American cases suggest that the fact that an insider trades in securities after he or she comes into possession of information will support an inference that a reasonable person would have been influenced by that information in determining whether to trade in those securities.[87]

The American insider trading cases suggest that the question of materiality is, in practice, unlikely to be a matter of significant dispute. An insider would only be likely to make a significant profit from trading on information which will give rise to a significant change in the price of the securities when it is publicly released. American insider trading cases have typically involved information such as a company's earnings; impending takeover offers or share placements; mineral discoveries[88] or new products; significant changes in dividend rates[89] or management policies; or fundamental changes in the financial position of a company.[90] Knowledge of the impending publication of a research report by a broking firm or of a significant change in a house position of the firm is also likely to be material. Events of that kind are likely to influence the trading decisions of persons who commonly invest in securities in deciding whether or not to deal in that security, and also to have a material effect on the price or value of securities of that company.[91]

In the Court of Appeal in *Hooker Investments Pty Limited v Baring Brothers Halkerston Securities Limited*,[92] McHugh J observed that the "materiality" of information under s 128 of the *Securities Industry Code* was class-specific, so that "[p]ossession of information likely to affect the price of one or more securities of a body corporate does not preclude the possessor from dealing in other securities of that body corporate".[93] That conclusion was plausible in relation to s 128 of the *Securities Industry Code*, where the test of materiality was based on the effect of information on the market price of securities rather than on investor judgment. However, it is arguable that information as to one class of securities might in some circumstances be regarded by the reasonable investor as important for his or her investment decisions as to other classes.

---

86 DC Langevoort *ibid.*

87 *SEC v Texas Gulf Sulphur Company* note 39 *supra* at 851; JD Cox note 23 *supra* at 470; DC Langevoort *ibid.*

88 *SEC v Texas Gulf Sulphur Company*, *id.*

89 *Cady Roberts & Co v SEC* note 37 *supra.*

90 *Shapiro v Merrill Lynch, Pierce Fenner & Smith Inc* note 41 *supra.*

91 DC Langevoort note 22 *supra* at 144.

92 (1986) 10 CLR 524; (1986) 5 NSWLR 157.

93 *Ibid* at 528; 162.

IX. WHETHER INFORMATION IS PUBLICLY AVAILABLE

It is fundamental to the concept of insider trading that the information upon which the insider trades is not generally available to investors in the market.[94] In principle, an insider should be able to avoid liability for insider trading by disclosing the particular information on the basis of which he or she proposes to trade, allowing others in the market the ability to take account of that information. Trading between an insider and others following assimilation of information by the market does not violate the access to information principle, since each investor in the market will have the ability to take the information into account, and since (on the "efficient capital market" hypothesis) the market price of the shares will in any event reflect the effect of the release of that information to the market.[95]

In order to fall within the scope of s 1002G, it is necessary that a person possesses information that is not generally available. The Griffiths Committee recommended that information be treated as generally available if it is disclosed in a manner which would, or would be likely to, bring it to the attention of a reasonable investor, and if a reasonable period of time for dissemination of the information has elapsed.[96] Section 1002B has the effect that information is taken to be generally available if:

- it consists of readily observable matter: s 1002B(2)(a); or
- it has been made known in a manner that would, or would be expected to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information and a reasonable period for it to be disseminated among such persons has elapsed since it became known: s 1002B(2)(b); or
- it consists of deductions, conclusions or inferences made or drawn from either readily observable matter or information made known as mentioned in s 1002B(2)(b)(i): s 1002B(3).

Section 1002B(2)(b) contemplates that information may be made known in a manner that would, or would be expected to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information. The Explanatory Memorandum to the *Corporations Legislation Amendment Act* 1991 noted that, for the purposes of this provision, "[i]t would not be sufficient for information to be released to a small sector of the investors who commonly invest in the securities. The information must be made known to a cross section of the investors who commonly invest in the securities."[97] This provision appears to allow announcements of matters affecting the securities of listed companies to be

94 *Kinwat Holdings Pty Ltd v Platform Pty Ltd* (1982) 1 ACLC 194.

95 P Anisman note 3 *supra* p 74; AJ Black note 1 *supra* at 653; DC Langevoort note 22 *supra* at 151.

96 Note 4 *supra* at [4.5.9].

97 *Explanatory Memorandum* at [328].

made by a means that would be expected to come to the attention of investors in such companies, for example by an announcement to the Australian Stock Exchange.

Some difficulties remain in determining whether information is publicly available, particularly in the context of internationalisation of the securities markets. Consider, for example, price-sensitive information relating to a company which has its primary listing on the Hong Kong Stock Exchange but is also listed as an exempt foreign company on the Australian Stock Exchange. Is that information publicly available, for the purposes of s 1002B, if it has been announced to the Hong Kong Stock Exchange but not yet to the Australian Stock Exchange, and could be obtained by an alert investor following the international markets? In the case of a company listed only in Australia, an announcement to the Hong Kong Stock Exchange would clearly not be sufficient to have the effect that the information is publicly available for the purposes of s 1002B. However, there is at least an argument that an announcement to the Hong Kong Stock Exchange would be expected to bring information to the attention of persons who commonly invest in securities of a body corporate which has its primary listing in Hong Kong and a secondary listing in Australia. In practice, Rule 3A(18B) of the Listing Rules of the Australian Stock Exchange requires a listed company to give notice to the Exchange of any document lodged in an overseas jurisdiction containing "market sensitive information" which has not previously been disclosed to the Exchange.

Section 1002B(2)(b) requires that a reasonable period for information to be disseminated among persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information, has elapsed since the information became known: s 1002B(2)(b). The Explanatory Memorandum to the *Corporations Legislation Amendment Act* 1991 noted that this requirement was "intended to prevent an insider, who is aware of information prior to its release, getting an unfair head start on other market participants", but not to require an embargo on trading "of such duration that it constitutes and impediment to the efficient operation of the market". This is consistent with the approach adopted in the American courts in relation to Rule 10b-5: for example, in *SEC v Texas Gulf Sulphur Company*,[98] the Court held that Rule 10b-5 required an insider to refrain from trading for some time after the disclosure of information, so as to prevent him gaining a head start in the period required for the assimilation of that information by the market.

In practice, s 1002B(2)(b) will require insiders to reach relatively fine judgments as to whether a reasonable period has elapsed since information became known, for that information to be disseminated among persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information. It will be difficult to develop any general rule as to the time which is a reasonable time for this purpose. It is

98 Note 39 *supra* at 848; *Cady Roberts & Co* note 37 *supra* at 912.

likely that the time required for the market to assimilate information which relates to a security which is thinly traded will be greater than the time required to assimilate information which relates to a security that is traded in significant volumes. The time required for information to be "disseminated" among investors may also depend upon the complexity of the information, if that term is taken to require not only that information is available to investors but also that it has been understood by the market: for example, the effect of a decline in anticipated earnings of a company or a reduced dividend payment would typically be quickly assimilated by the market, whereas the implications of a complex restructuring or a significant acquisition may not be immediately apparent.[99]

The prohibition against an insider trading immediately after the release of information to the market has been criticised on the ground that it merely changes the order in which investors trade following the release of information, since insiders within its scope are unable "to trade the relevant securities for, say, a couple of days, but alert 'outsiders' would be able to trade immediately."[100] It has been suggested that, if abnormal trading returns may be achieved during the period of time between release of information to the market and its absorption, then the effect of prohibiting the insider from trading immediately following public disclosure is to secure those profits to the alert outsider.[101] It may be argued that there is a prophylactic justification for any disadvantage to an insider who is restricted from trading in a particular security in a period when outsiders are not so restricted, even if the alert outsider profits from a trading window as against the insider.[102]

As noted above, there is a close relationship between the extent of insider trading, on the one hand, and the extent of timely disclosure of material information by listed companies on the other. Opportunities for insider trading will exist if a company fails to disclose material information to the market in a timely fashion. Amendments to Rule 3A(1) of the Listing Rules of the Australian Stock Exchange, effective from 1 January 1992, require a listed company to notify the Exchange of any information which investors and their professional advisors would reasonably require, and reasonably expect to be disclosed to the market, for the purpose of making an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the company; and of the rights attaching to securities of the company. If rigorously enforced by the Exchange, Listing Rule 3A(1) will reduce the opportunities for insider trading in the securities of listed companies by increasing the extent to which information is available to the market.

---

99 DC Langevoort note 22 *supra* at 153, 231.
100 Note 26 *supra* at 47.
101 *Ibid* at 48.
102 AJ Black note *supra* at 653.

X. ANALYSIS OF PUBLICLY AVAILABLE INFORMATION

The access to information approach emphasises the opportunity to obtain information, and therefore recognises that an investor who obtains information through research or analysis is entitled to take advantage of that information, since others in the market could obtain that information given equal effort.[103] On that view, trading on inside information is objectionable - by contrast with trading on the basis of information acquired by research or analysis of publicly available information - because it denies the other party the opportunity to lawfully overcome the information advantage held by the insider.[104]

It has been argued that the search by investment analysts for information as to securities and the analysis of that information results in a greater amount of information being reflected in the market price of securities. On this view, "professionally informed" trading (which incorporates information that is publicly available but is not widely disseminated since its analysis requires expertise) has the result that the price at which securities are traded more accurately reflects the available information relating to those securities.[105] Investment analysts and professional investors should therefore be permitted to analyse publicly available information, in the interests of the efficient operation of the market. Section 1002B(3) treats information as being generally available if it consists of deductions, conclusions or inferences made or drawn from either readily observable matter or information made known in a manner that would, or would be expected to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information. An investor is therefore not prohibited from trading if he or she possesses information which is derived from the analysis of publicly available information. A prohibition on trading in those circumstances would have been a significant disincentive against investment analysts and professional investors undertaking that analysis.

Greater difficulty arises from the communication of information, which is not otherwise known to the market, to investment analysts. In *Dirks v SEC*,[106] Powell J (speaking for the majority in the US Supreme Court) observed that the nature of nonpublic information "and indeed of the markets themselves" was such that "information cannot be made simultaneously available to all of the corporation's stockholders or the public generally."[107] His Honour recognised the function of investment analysts in sustaining the efficient operation of the securities market, observing that:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an

103 V Brudney note 22 *supra* at 341-2; note 69 *supra* at 539; AJ Black note 1 *supra* at 646.

104 V Brudney *ibid* at 355, 360.

105 RJ Gilson and RH Kraakamn "The Mechanisms of Market Efficiency" (1984) 70 *Virginia L Rev* 549 at 569-570.

106 Note 46 *supra*.

107 *Ibid* at 659.

> inhibiting influence on the role of market analysts, which the SEC itself recognises is necessary to the preservation of a healthy market. It is common place for analysts to 'ferret out' and analyze information... and this is often done by meetings with and questioning of officers and others who are insiders.[108]

The Court reasoned that the socially desirable activities of security analysts would be reduced or extinguished if a tippee could be held liable for insider trading in the absence of wrongful conduct by the insider who revealed the information to the tippee. American law therefore permits an investment adviser to trade on material non-public information communicated to him by an officer of a company, or to communicate that information to others, provided that the communication by the company officer was made for proper business purposes and not for the personal benefit of that officer.[109]

The protection afforded to investment analysts under s 1002B(3) is narrower than that which is available under American law.[110] Section 1002B(3) would not protect an investment adviser or institutional investor which traded on the basis of information obtained, for example, from a private contact with company officers. It may be that information which is conveyed to an investment analyst in such a contact would generally not be of sufficient significance, in itself, to pass the threshold for the application of s 1002G. Information communicated to an analyst will only pass that threshold if a reasonable person would expect the information to have a material effect on the price or value of securities of the body corporate: however, s 1002C has the effect that a reasonable person is taken to expect the information to have such an effect if it "would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell" the relevant securities. If information communicated to an investment analyst meets that test, s 1002G(2) prevents the analyst trading on that information and s 1002G(3) prohibits communication of the information to others. If a securities dealer did not have a chinese wall in place, the communication of that information to a single investment analyst would prevent any trading by that dealer in securities of the relevant company.

XI. PROHIBITED ACTS UNDER S1002G

If s 1002G applies, an insider is prohibited from subscribing for, purchasing or selling securities or entering into an agreement to do so, or procuring another person to subscribe for, purchase or sell securities or enter an agreement to do so: s 1002G(2). The term "procure" is defined in s 1002D(2), without limiting the meaning of that term at general law, as including inciting, inducing or

---

108 *Ibid* at 662.

109 *Ibid* at 662-664. For this purpose, a personal benefit would include a monetary or reputational benefit to the corporate officer, and also the benefit implicit in a gift of information to a friend or associate of the officer. See DC Langevoort note 27 *supra* at 1033, 1051.

110 *Dirks v SEC* note 46 *supra*; DC Langevoort *ibid* at 1023.

encouraging an act or omission by another person.[111] If trading in the relevant securities is permitted on the stock market of a securities exchange, an insider is also prohibited from communicating the information, or causing it to be communicated, to another person if the insider knows, or ought reasonably to know, that the other person would be likely either to subscribe for, purchase or sell securities, enter an agreement to do so or procure another person to do so: s 1002G(3).

A natural person is not prohibited from entering into a transaction under s 1002G(2) merely because that person is aware of his or her previous or proposed transactions in respect of those securities, even if a reasonable person would expect the information as to those transactions to have a material effect on the price of the securities if it were generally available: s 1002P. This exemption would apply, for example, if a trader sold a small number of securities while knowing that he or she intended to later sell a larger number of those securities.

It is a defence to a contravention of s 1002G(2) and s 1002G(3) if information came into a person's possession solely as a result of information being made known in a manner that would, or would be expected to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information: s 1002T(2)(a), s 1002T(3)(a). The defence would be available if the information has been announced to the market, even if it has not become known to the particular investor who is the other party to the trade; and would be available even if a reasonable time after publication of the information has not elapsed, if the person who traded on or communicated the information came into possession of that information solely as a result of its publication. This defence would be available to an institutional investor or market professional which traded on the basis of publicly available information immediately after its release, but before the majority of investors had digested its significance; and can be justified as protecting the efforts of investment analysts and institutional investors to assimilate information released to the market.

It is also a defence to a contravention of s 1002G(2) and s 1002G(3) if the Court is satisfied that the other party to the transaction or agreement knew, or ought reasonably to have known, of the information before entering into the transaction or agreement or before the information was communicated: s 1002T(3)(a), s 1002T(3)(b). This defence is likely to be available only if information which is known, or ought reasonably to have been known, to the other party is of the same quality as that which is known to the insider. For example, the defence is unlikely to be available if a possible transaction is the subject of rumours in the market which are or should have been known to the other party to the transaction, but the insider is aware that the transaction is a certainty. Similarly, the existence of speculation in the market as to the amount of the profit or loss which will be announced by a company should not allow a

111 Butterworths *Australian Corporation Law* at [7.3.0060].

defence under s 1002T to a person who trades with actual knowledge of the company's results, since the information known to that person is qualitatively different from the information which is known or ought reasonably to have been known to other traders.

The *Corporations Legislation Amendment Act* 1991 does not introduce any equivalent to s 16 of the *Securities Exchange Act* 1934 (US). Section 16(a) of the *Securities Exchange Act* requires a director or officer of the issuer of a registered equity security, and the beneficial owner of more than 10% of equity securities in the issuer, to report transactions in the company's securities to the SEC. Section 16(b) requires an insider of a company to disgorge to the company any profit made as a result of buying or selling securities of the company within 6 months of an earlier sale or purchase of the securities, in an action brought by the company. The fact that the director, officer or substantial shareholder has not used material nonpublic information in his or her trading does not establish a defence to the obligation to disgorge any profit made within the six month period. In the United States, that section reduces the opportunities for insider trading by company officers, at least over relatively short periods, by denying the short-term profits made from investments in shares in a company to an officer of that company.

XII. COMMUNICATION OF INSIDER INFORMATION

The former s 1002(5) prohibited a person who was precluded from dealing under s 1002(1), s 1002(2) or s 1002(3) from communicating price-sensitive information relating to quoted securities to a third party if he or she knew, or ought reasonably to have known, that the other person would make use of the information for the purpose of dealing or causing or procuring another person to deal in the securities. Following the amendments made by the *Corporations Legislation Amendment Act* 1991, s 1002G(3) prohibits a person from:

- (i) directly or indirectly communicating material nonpublic information within the scope of s 1002G to another person; or (ii) causing that information to be communicated to the other person;
- if trading on securities is permitted on the stock market of a securities exchange; and
- the insider knows, or ought reasonably to know, that the other person would be likely to (i) subscribe for, purchase or sell, or enter into an agreement to subscribe for, purchase or sell, the securities; or (ii) procure another person to subscribe for, purchase or sell, or to enter an agreement to subscribe for, purchase or sell any such securities.

That section applies to securities which are ordinarily permitted to be traded on the stock market of a securities exchange, even if trading in those securities

has been temporarily suspended by the exchange or by notice given by the ASC to that exchange under s 775(2): s 1002D(2).

Consider, for example, the situation arising if a company officer advises a business associate of an anticipated transaction in which that associate is a potential investor, under an express obligation of confidentiality and expecting that the business associate will not use that information for the purposes of trading in the securities. In these circumstances, the officer would not contravene s 1002G(3), since he or she would neither know nor ought reasonably to know that the business associate would trade on that information. However, the business associate would contravene s 1002G(2) if he or she traded on that information at a time at which it was not generally available, if a reasonable person would expect that information to have a material effect on the price or value of securities of a body corporate if it were generally available; and he or she knows, or ought reasonably to know, that the information might have a material effect on the price or value of those securities if it were generally available.[112]

The amendments to s 1002G(3) do not resolve the difficulty which arises where a company - for example the target company in a takeover or a company which requires a significant capital injection - provides material nonpublic information to another company to promote an acquisition of or a subscription for securities. Consider, for example, the facts of *ICAL Limited v County Natwest Securities Australia Ltd*,[113] where a merchant bank retained by the target company communicated price-sensitive information to a possible rival bidder so as to encourage the making of a takeover bid by that bidder. Bryson J took the view that the prohibition on tipping under s 128 of the *Securities Industry Code* had to be reconciled with the fiduciary duty of the directors of the target company to seek the highest price for the company's shares in a takeover, and declined to grant an injunction to restrain the target company and its directors from causing or procuring any person to acquire or dispose of shares in the company while the relevant price-sensitive information was not generally available.[114] In the writer's view, that decision may be read as authorising disclosure of the information by the target company or its representatives to a potential bidder, but cannot be read as permitting a potential bidder to purchase shares in the target company unless the relevant information had first been made publicly available. Read in this way, the *ICAL Case* is consistent with the access to information theory. It is also consistent with the misappropriation theory adopted by the American courts, since disclosure of material nonpublic information to a potential bidder is a proper use of that

112 *SEC v Lund* 570 F Supp 1397 (CD Cal 1983), where the Court held the business colleague liable under Rule 10b-5 on the ground that he had become a "temporary insider" of the company when he was given information in the expectation that he would keep it confidential.

113 (1988) 6 ACLC 467.

114 *Ibid* at 502.

information by directors of the target company, which serves the interests of the target company and its shareholders.[115]

By contrast, s 1002G(3) prohibits the merchant bank communicating material price sensitive information to a potential bidder if it knew, or ought reasonably to know, that the potential bidder would subscribe for, purchase or sell securities of the target company or agree to do so, or would procure another person to do so. It might be thought that it should be open to the target company or merchant bank to communicate the relevant information to the potential bidder conditional upon an agreement by the bidder that it will not purchase, sell or subscribe for securities in the company or agree to do so, or communicate the information to a third party, unless the relevant information has been made public by the company. If such an agreement existed, the target company or merchant bank would be entitled to assume that the potential bidder would not purchase or sell or subscribe for securities in the company until the information which it had communicated was publicly available. However, on the face of s 1002G(3), the prohibition applies to communication of material nonpublic information if the insider knows, or ought reasonably to know, that the other person would be likely to subscribe for, purchase or sell securities of the company, or enter into an agreement to do so or procure another person to do so, even if the transaction by the other person will occur at a time at which the information no longer has the character of material nonpublic information.[116] This result is obviously inconsistent with the recognition of the fiduciary duty of the directors of the target company to seek the highest price for the company's shares in the face of a takeover bid such as in the *ICAL Case*.[117]

XIII. TREATMENT OF TIPPEES

Prior to the amendments made by the *Corporations Legislation Amendment Act* 1991, s 1002(3) prohibited a tippee from dealing in securities if, at the time he or she received material price-sensitive information from a person who was prohibited from dealing in the securities, there existed an association with the insider who provided the information or an arrangement for the communication of that information with a view to dealing in securities. In order to establish that a tippee was liable under s 1002(3), it was therefore necessary to establish the existence of such an association or arrangement. That requirement focussed on the wrong by the tippee in seeking to take advantage of information conveyed by an insider, rather than on the effect of the tippee possessing such information while trading in the market.[118] The Attorney-General's

115 JD Cox note 23 *supra* at 469.

116 Butterworths *Australian Corporation Law* at [7.3.0060].

117 Note 113 *supra*.

118 AJ Black note 1 *supra* at 658; for the contrary view, see JD Cox note 23 *supra* at 466-467.

Department's Submission to the Griffiths Committee noted that the requirement in s 1002(3) that there existed an arrangement or association between an insider and his or her tippee avoided the risk that a person could be held liable as a tippee where he or she was not aware that the relevant information was confidential.[119]

By contrast, the Griffiths Committee characterised the purpose of the former s 1002(3) as being "to prevent persons (including corporations) from using inside information received from insiders to trade in or subscribe for the securities of the company which is the subject of the information", and concluded that the need to demonstrate an association between the tippee and the insider detracted from that purpose. The Committee recommended that the insider trading provisions be amended to include tippees within the primary definition of insider.[120] A tippee who obtains price-sensitive information obtains the same information advantage as against others in the market, and the same ability to trade at substantially lower market risk, as is available to the insider who initially possessed that information.[121] On access to information reasoning, the tippee's trading is objectionable as a use of material information which is not the consequence of the tippee's research or investigation, allowing an advantage which cannot be eroded by others in the market.[122]

Section 1002G applies to tippees in the same way as it applies to insiders. The effect of applying s 1002G to tippees may be illustrated by reference to the facts of *Attorney-General's Reference (No 1 of 1988)*.[123] A merchant bank informed a potential bidder ("bidder") for shares in a listed company, under an express obligation of confidentiality, that the listed company had reached agreement for a merger with another company and that a takeover announcement would be made shortly. The bidder purchased shares in the target company prior to that announcement, and sold them at a profit several weeks after the announcement. At first instance, the Court held that the bidder had not contravened the *Company Securities (Insider Dealing) Act* 1985 (UK), on the ground that he had taken no active steps to seek the relevant information from the merchant bank. The House of Lords held that he should have been found liable on the relevant facts. A person in the position of the bidder would not have been liable as a tippee under the former s 1002(3), in the absence of an association with the merchant bank or an arrangement for the communication of that information with a view to dealing in securities. By contrast, s 1002G applies where a person possesses information that is not generally available; a reasonable person would expect that information to have a material effect on the price or value of securities of a body corporate if it was generally available; and the person knows, or ought to know, that the information is not generally

119 Submission of the Attorney-General's Department to the Griffiths Committee, s 543.

120 Note 4 *supra* recommendation 7 at [4.7.10.]

121 Note 3 *supra* at 24.

122 V Brudney note 22 *supra*; DC Langevoort note 43 *supra* at 10; AJ Black note 1 *supra* at 656.

123 (1989) 2 WLR 195; (1989) 2 All ER 321.

available and that it might have a material effect on the price or value of those securities, if it were generally available. That section would apply to a person in the position of the bidder in *Attorney-General's Reference (No 1 of 1988)*.[124]

It is clear that s 1002G may give rise to a different result than the application of American authorities decided under Rule 10b-5. Consider, for example, the facts of *Dirks v SEC*.[125] In that case, a former employee of a life insurance company communicated allegations of a fraudulent overstatement of the assets of that company to Dirks, an investment analyst. Dirks in turn conveyed that information to a number of other advisers and to several institutional clients, which sold down their holdings in the company. The US Supreme Court held that Dirks could only be held liable as a tippee if he had knowingly participated in a breach of fiduciary duty by the insider. The Court noted that such participation could be established if disclosure by the insider was wrongful and the tippee knew or had reason to know that the insider would benefit from passing on the tip, whether by way of a financial or reputational benefit or because the insider had conveyed the information to a friend or relative.[126] Since the conduct of the employee who had passed the relevant information to Dirks in order to expose a fraud was not wrongful, the conduct of Dirks in passing that information to others did not contravene Rule 10b-5.[127] By contrast, a person in the position of Dirks would be treated as falling within the scope of s 1002G, since he or she would possess information that was not generally available; which a reasonable person would expect to have a material effect on the price or value of securities of the insurance company if it were generally available; and which he or she knew, or ought to have known, was not generally available and might have a material effect on the price or value of those securities if it were generally available. That person would be prohibited from trading in the securities: s 1002G(1). That person would also be prohibited from directly or indirectly communicating the information, or causing the information to be communicated, to his or her clients or other investment advisers since he or she knew, or ought reasonably to have known, that those persons would be likely to sell the securities or to encourage their clients to do so: s 1002G(3).

Consider also the facts of *Carpenter v US*,[128] where two brokers received information as to the content of columns written by Winans, and traded profitably by anticipating the likely market effect of those columns. Under the former s 1002(3), the brokers would not have been prohibited from trading since a journalist in the position of Winans would not be connected with the companies whose shares were traded for the purposes of s 1002(9), and therefore was not precluded from dealing in securities of those companies under

124 *Id.*
125 Note 46 *supra*.
126 *Ibid* at 659.
127 *Ibid* at 666-667.
128 Note 51 *supra*.

s 1002(1) or s 1002(2). Under s 1002G(2), once the brokers obtained information as to contents of a future column from a person in the position of Winans, they would be prohibited from trading if the contents of the column were not yet generally available, and a reasonable person would have expected the information contained in that column to have a material price on the effect of securities in a company when it became generally available; and if the brokers knew or ought reasonably to have known that the information was not generally available and that it might have a material effect on the price of the securities if it were generally available. In these circumstances, the position of the primary insider (Winans) and his tippees (the brokers) are treated in the same manner.

Section 1002G would also apply, for example, to a person who had no arrangement with an insider for the communication of information but who obtained that information by overhearing a conversation between the insider and another person, or as a result of an accidental disclosure by the insider, if the nature of the information was such that the person ought reasonably to have known that the information was material nonpublic information.

XIV. EXEMPTIONS FOR UNDERWRITERS AND SUB-UNDERWRITERS

Section 1002G expressly extends to a subscription for securities, reversing the decision of the Court of Appeal of the Supreme Court of New South Wales in *Hooker Investments Pty Ltd v Baring Brothers Halkerston Securities Ltd*,[129] which held that s 128 of the *Securities Industry Code* was limited to dealings in issued securities. However, an exemption from s 1002G(2) is available for a subscription for securities under an underwriting agreement or a sub-underwriting agreement and in respect of entry into such an agreement: s 1002J(1)(a)-(b). The exemption from s 1002G(2) extends to the sale of securities subscribed for under an underwriting agreement or sub-underwriting agreement: s 1002J(1)(c). That exemption has the result that an underwriter or sub-underwriter which has obtained material nonpublic information is not prevented from placing securities by the fact that it possesses that information. However, the exemption would not permit the underwriter or sub-underwriter to sell other securities of the same kind as those which it subscribed for under the underwriting agreement of sub-underwriting agreement while the relevant information remained material and nonpublic. The exemptions available to underwriters and sub-underwriters are justifiable in policy, since there is generally no inequality of information between an issuer and an underwriter in negotiating an underwriting agreement for a new issue of shares.[130]

129 (1986) 10 ACLR 524; 5 NSWLR 163 (Court of Appeal).

130 *Id* (Court of Appeal) per McHugh J at 529.

Section 1002J(2)(a) allows an exemption from the prohibition on communication of material nonpublic information under s 1002G(3), if information is communicated solely for the purpose of procuring a person to enter into an underwriting agreement. Exemptions from s 1002G(3) are also available if information is communicated by an underwriter solely for the purpose of procuring another person to enter a sub-underwriting agreement or to subscribe for securities: s 1002J(2)(b). The latter exemption does not permit trading in issued securities by subscribers who have obtained material nonpublic information from underwriters, so long as the information remains material and nonpublic. The exclusion of persons who have received material nonpublic information from underwriters from the secondary market, until the information ceases to be price-sensitive or is made public, will tend either to discourage such communications by underwriters - since institutional investors are likely to be reluctant to be provided with information which would prevent trading in the securities for an indeterminate period - or to encourage disclosure of that information to the market so as to allows the subscribers to whom the information was communicated to trade.

Professor Tomasic has argued that the exemption for information communicated by underwriters to subscribers for securities "is an invitation to significant abuse as brokers have been shown to be more likely than other industry actors to be very prone to take advantage of inside information."[131] The fundamental question is whether the public interest in the primary market for new issues of securities requires that underwriters and sub-underwriters be permitted to communicate material price-sensitive information to subscribers, to allow the effective performance of their functions. That question is not answered by Professor Tomasic's assertion that brokers are prone to undertake insider trading (whether or not that assertion is sustainable as a matter of fact), in the absence of any consideration of whether it would be possible to put underwriting arrangements for public issues of securities in place if underwriters were to be prevented from communicating information to potential subscribers.

XV. CHINESE WALLS WITHIN COMPANIES AND PARTNERSHIPS

Section 1002G(2) is not contravened by a body corporate which enters into a transaction or agreement when an officer of that body corporate possesses material nonpublic information, if certain requirements are satisfied: s 1002M. These are that:

131 R Tomasic "Insider Trading Law Reform in Australia, note 5 *supra* at 141. In support of the proposition that brokers are more likely to undertake insider trading than others, Tomasic cites R Tomasic and B Pentony "Crime and Opportunity in the Securities Industry" note 5 *supra*.

- the decision to enter into the transaction or agreement was taken on behalf of the body corporate by a person other than the officer who possessed the relevant information;
- the body corporate had in operation arrangements that could reasonably be expected to ensure that the information was not communicated to the person who made the decision, and that no advice with respect to the transaction or agreement was given to that person by a person in possession of the information; and
- the information was not in fact communicated to the person who made the decision, and no such advice was given to that person by a person in possession of the information.

A corresponding defence is available for trading by partnerships under s 1002N(1). Professor Tomasic has suggested that "it is difficult to see the partnership exception as being little other than the product of special pleading."[132] The writer finds it difficult to follow the basis for this suggestion. The defence for partnerships is necessary since a partner is deemed to possess information that another partner or an employee of the partnership possesses by virtue of his or her position as a partner or employee; and since it is presumed that a partner knows or ought to know that information is not generally available and that it might have a material effect on the price or value of securities if another partner or an employee knows or ought to know those matters: s 1002F. If a chinese wall defence is to be available to incorporated brokers, competitive equality (rather than "special pleading") requires that the defence also be available to broking firms which trade as partnerships.

If a body corporate or partnership cannot establish that a chinese wall is in place, it may be held liable under s 1002G if it trades while material nonpublic information is possessed by an officer of the body corporate or by a member or employee of the partnership, even if the relevant decision was made by a person who did not in fact possess the information.[133] A chinese wall is intended to restrict the passing of price-sensitive information to employees or departments of a company or partnership engaged in trading or in advising where that information arises from a confidential relationship with a corporate client. The chinese wall will typically be characterised by "policies and procedures governing dissemination of the information and on occasion through physical separation of departments".[134] Such policies should be documented; should involve physical access restrictions and document control procedures including limits on access to sensitive material held in computer files; separate supervision of divisions on opposite sides of the chinese wall, except at senior

132 R Tomasic "Insider Trading Law Reform in Australia" note 5 *supra* at 142.

133 *Sun Securities Ltd v NCSC* (1990) 2 ACSR 796 per Ipp J at 807-808; Butterworths *Australian Corporation Law* at [7.3.0080].

134 Note 3 *supra* p 82; LE Herzel and DE Colling "The Chinese Wall and Conflict of Interest in Banks" (1978) 34 *Business Lawyer* 73 at 88.

management level; and, if possible, limits on transfers between the corporate advisory section and the trading desk of a broking firm.[135] Those policies should be reinforced by continuing education programmes and by imposing disciplinary sanctions for breach. It may also be appropriate for the firm to require employees to report their personal trading, and to monitor trading by the firm on its own account, to detect any sign of breach of the chinese wall.[136]

The practical effectiveness of chinese wall procedures remains a matter of some controversy. The Australian Merchant Bankers Association and a substantial institutional investor each gave evidence before the Griffiths Committee that chinese walls were effective, given adequate enforcement; whereas Professor Tomasic and Mr Pentony "questioned the appropriateness of the Chinese Wall defence".[137] It has to be accepted that chinese walls are difficult to establish in a firm with a small number of employees performing common functions. There is some risk of accidental leakage of information where a chinese wall is in place, as a result of informal dealings between staff in the separated departments or transfer of staff from one department to another; or as a result of access to information relating to departments on opposite sides of the chinese wall by executive management of the firm.[138] It will be necessary for the firm's compliance department to have access to information held on both sides of a chinese wall - such as the identity of clients, the nature of material nonpublic information held by the firm, and trades undertaken by the dealing desk - in order to detect insider trading. That access should not prejudice the effectiveness of the chinese wall provided that compliance functions on the one hand and dealing and advising functions on the other are performed by different persons. If a chinese wall operates effectively in a larger firm, it may do so only at the cost of preventing the firm from drawing on the expertise of employees and management on the other side of the chinese wall.

The Griffiths Committee concluded that insufficient evidence had been provided to suggest that chinese walls were not effective. Professor Tomasic has in turn argued that the Committee's conclusion "is simply not sustainable upon the basis of the limited empirical research which has been conducted into this aspect of the Australian securities industry."[139] However, there appear to have been significant differences of opinion as to whether chinese walls are effective in practice among the persons whose responses are reported by

135 DC Langevoort note 22 *supra* at 403, 406; CA Quinn "The Securities Amendment Act 1988 and the Chinese Wall" (1989) 7 *Otago L Rev* 41.

136 DC Langevoort *ibid* at 249.

137 Note 4 *supra* at [4.9.4]-[4.9.5]. Mr Pentony is there quoted as having given evidence that "[t]here has never been a Chinese Wall without a grapevine." The same comment is attributed to a Perth lawyer in R Tomasic and B Pentony "Insider Trading Regulation and Law Enforcement in Australia" note 5 *supra* at 80; and is also quoted in R Tomasic *Casino Capitalism* note 5 *supra* p 92.

138 NS Poser "Chinese Wall or Emperor's New Clothes" (1988) 9 *Company Lawyer* 119 (Pt 1) at 159, (Pt 2) at 203, (Pt 3) at 203-207; P Anisman note 3 *supra* p 82.

139 R Tomasic "Insider Trading Law Reform in Australia" note 5 *supra* at 133. See also R Tomasic "Chinese Walls, Legal Principle and Commercial Reality in Multi-Service Professional Firms" (1991) 14 *UNSWLJ* 46.

Tomasic and Pentony.[140] In the absence of a common view that chinese walls were not effective among the persons interviewed, it is difficult to see that the research of Tomasic and Pentony can be said to contradict the conclusions of the Griffiths Committee. Moreover, s 1002M and s 1002N place the onus upon a company or partnership which seeks to obtain the benefit of the chinese wall defence, to demonstrate that its internal procedures for restricting the flow of information could "reasonably be expected to ensure" that the information was not communicated across the chinese wall.

In arguing that a defence should not be available to companies and partnerships based on the existence of a chinese wall, Tomasic relies on *Mallesons Stephen Jaques v KPMG Peat Marwick*[141] and asserts that "[t]here is no reason why the observations made in this case should not be applied to other professional-client relationships, such as those found in the securities industry."[142] That case turned on the rule against a solicitor placing himself or herself in a position where competing duties are owed to a present and a former client, which was applied strictly in the context of criminal proceedings. Justice Ipp did not reach any generalised findings of fact as to the effectiveness of chinese walls. The solicitor-client relationship is one of particular sensitivity, given the likelihood that confidential information will be imparted by a client to his or her solicitor, while (as Justice Ipp recognised) the application of the rule against conflict of interest to solicitors is reinforced by the public interest in the administration of justice. By contrast, a securities broker is a fiduciary to its client in a more limited sense, since it typically trades in a competitive market where the price of the commodity is set by a large number of individual trades in an impersonal market and where the broker has limited ability to influence that price by negotiation with the other party to the transaction: *Jones v Canavan*.[143] The decision in *Mallesons Stephen Jaques v KPMG Peat Marwick*[144] does not address the question of whether, as a matter of policy, chinese walls should be permitted in merchant banks or broking firms.

The American experience of the operation of the chinese wall defence suggests that one should not too readily accept the view that a chinese wall defence should not be available to companies and partnerships. For example, Rule 14e-3, made by the Securities & Exchange Commission under s 14(e) of the *Securities Exchange Act* (US), prohibits trading in securities by a person who has acquired material nonpublic information relating to a tender offer for those securities from the offeror or the target company. Rule 14e-3 allows a specific defence to a securities dealer which acquires securities while it possesses material nonpublic information as to a tender offer, if the person who made the decision to acquire the securities did not possess the relevant

140 R Tomasic and B Pentony "Insider Trading Regulation and Law Enforcement in Australia" note 5 *supra* at 76-81.

141 Ipp J, unreported, Supreme Court of Western Australia, 19 October 1990.

142 R Tomasic "Insider Trading Law Reform in Australia" note 5 *supra* at 133.

143 [1972] 2 NSWLR 236 per Jacobs J at 245.

144 Note 150 *supra*.

information, and the dealer establishes that it has reasonable safeguards in place (typically, a chinese wall) to prevent communication of that information from the section which obtained that information to the dealer's trading department.[145]

Compelling reasons should be required for denying the availability of a chinese wall defence to securities intermediaries and merchant banks, since the effect of doing so would be to require separation of dealing and corporate advising functions, imposing substantial economic costs and excluding desirable synergies available from sharing of research, administrative and other facilities.[146] In the writer's view, the reasons advanced by Tomasic and Pentony for denying such a defence fall well short of that standard.

XVI. THE ONUS OF PROOF IN INSIDER TRADING PROSECUTIONS

Some commentators have argued that insider trading should be decriminalised, so as to reduce the burden of proof upon the prosecution in insider trading prosecutions. This argument assumes that the reduction of the standard of proof of insider trading contraventions from "beyond reasonable doubt" to that of the "balance of probabilities" would increase the likelihood that the courts would hold that a contravention had occurred.[147] That assumption may be questionable. A finding that a defendant had engaged in insider trading, even if made in civil proceedings, is likely to cause significant prejudice to the defendant's reputation and to expose the defendant to substantial penalties. The Court, as tribunal of fact, is therefore likely to require that it can reach a high degree of satisfaction as to the existence of any facts which are said to establish the contravention. The Griffiths Committee accepted that the criminal penalty for insider trading should be retained.[148] Indeed, the penalty for contravention of s 1002G has been increased, in the case of a natural person, to $200,000 or imprisonment for 5 years or both.

The prosecution must establish the relevant intention in criminal proceedings for a contravention of s 1002G. In *CAC v Bain*,[149] a Local Court rejected the argument that s 128 of the Securities Industry Code was a strict liability offence. The Court held that the prosecution must prove the mental element of the offence, and in doing so may rely on evidence of the relationships between the parties to the transaction, the way in which information was received by the accused, the actions taken by the accused on receipt of the information and his

145 GG Lynch and WE Morse note 47 *supra* at 11; note 138 *supra* at 207.

146 AJ Black note 1 *supra* at 662.

147 See, for example, JM Naylor "The Use of Criminal Sanctions by UK and US Authorities for Insider Trading: How Can the Two Systems Learn from Each Other" (1990) 11 *Company Lawyer* 53 (Part I), 83 (Part II).

148 Submission of Attorney-General's Department to the Griffiths Committee, s 536.

149 Unreported (30 August 1988).

or her subsequent actions, the size of the transaction entered into by the accused, and the success or otherwise of the transaction. The Court noted that, for this purpose, it was necessary to have regard to the actual knowledge of the accused, rather than to knowledge which might be attributed to a person in the position of the accused; and that an inference as to knowledge of the accused could be drawn from surrounding circumstances, but only where it was the only inference available. The prosecution need not establish the absence of the facts or circumstances giving rise to specified statutory defences, although a defence will be established if the Court is satisfied that those facts existed: s 1002T(1).

Professor Tomasic has suggested that the onus of proof in insider trading prosecutions should be reversed on the grounds that "the matters raised by way of defence are usually peculiarly within the knowledge of the accused"; and that "spurious propositions" may be advanced by the defence which "almost any amount of prosecutorial resources will not be able to negate."[150] In the writer's view, this suggestion should be treated with considerable scepticism. It should not be assumed either that theories advanced by the prosecution are necessarily well-founded, or that explanations offered by defendants are necessarily untruthful. It is open to the prosecution to bring circumstantial evidence suggesting the existence of insider trading. This might include evidence that a particular pattern of trades or transactions was unusual, compared with trades typically undertaken by the defendant or by other traders in the market, coupled with evidence that the defendant had the opportunity to obtain inside information; evidence of a coincidence of timing between a trade undertaken by the defendant and a public announcement, particularly if the insider otherwise traded infrequently in securities; or evidence that a solicitor or accountant frequently made purchases of securities in companies for which he or she acted in a professional capacity.[151] If a trade is particularly large having regard to a defendant's financial resources, or if the interval between the time at which a defendant could have obtained the information and the time of the trade is relatively short, the Court will be more likely to infer that the defendant has traded on the basis of that information.[152] If the prosecution has led circumstantial evidence suggesting that a defendant has obtained access to and traded on material price-sensitive information, and the defendant offers a "spurious proposition" (in Professor Tomasic's phrase) in explanation of his or her motive for trading, that explanation may well be rejected by the tribunal of fact.

The argument that the onus of proof should be reversed in insider trading prosecutions was criticised in the Submission made by the Attorney-General's Department to the Griffiths Committee, which noted that a reversal of the onus of proof in respect of the offence generally could expose an officer of a

---

150 R Tomasic note 5 *supra* at 136.

151 GG Lynch and WE Morse note 47 *supra* at 21-22.

152 D Eisenberg "Insider Trading Law - Basic Principles and New Developments" in *Australian-United States Securities Regulations and Financial Institutions Conference* (1989) p 16.

company to a significant period of imprisonment if he or she purchased shares in the company and was unable to prove that he or she did not possess information that was not generally available.[153] However, that Submission argued that the reversal of the onus of proof could be supported in a narrower form. That Submission proposed that, in the case of an alleged contravention by a tipper, the prosecution should be required to prove that the defendant possessed information and passed that information to a third person; but that the onus of proof should be reversed as to question of whether the defendant knew that the tippee would use the information for the purposes of insider trading.[154] This proposal was supported by the argument that "it is very difficult for the prosecution to elicit independent evidence that the defendant knew that the tippee would use the information for the purpose of insider trading, but it is comparatively easy for the defendant to give evidence to deny the proposition." It may be that the argument for even a limited reversal of the onus of proof underestimates the prejudicial effect of such a reversal. In particular, a reversal of the onus of proof is likely to require an accused to give evidence in circumstances where he or she would not otherwise have done so.

The Griffiths Committee did not adopt the recommendation that the onus of proof be reversed: that decision may be supported as being consistent with the presumption of innocence in Australian criminal law. Moreover, as a matter of principle, it is difficult to see why a defendant should be held liable for insider trading if matters are equally balanced.

XVII. CIVIL REMEDIES FOR INSIDER TRADING

There are considerable difficulties in establishing a proper basis for the assessment of damages for insider trading, where that trading takes place on an impersonal market. Even in the absence of insider trading, available market information may not accurately reflect the underlying value of the securities, since information will frequently not be revealed to the market for commercial reasons.[155] In dealing on a stock exchange, purchasers and sellers of shares typically deal on the basis of market information without particular knowledge of the other party to the transaction. It is a consequence of the nature of an exchange-based transaction that the buying or selling insider will rarely have induced the other party to trade, while the fact that a trade occurs with an insider rather than with other persons in the market at the same time is essentially random. The fact that an insider has inside information will have no direct effect upon the price at which the transaction occurs,[156] although

153 Note 148 *supra* at s 538.

154 *Ibid* at s 539.

155 DC Langevoort note 43 *supra* at 18.

156 Note 26 *supra* at 48.

obviously that information might impact on the willingness of the other party to continue with the transaction if it were publicly known.

Section 1013 allows a range of civil remedies if a person contravenes s 1002G(2) by subscribing for, purchasing or selling securities or agreeing to do so, or by procuring another person to subscribe for, purchase or sell securities or agree to do so, when he or she possesses material nonpublic information as to securities of a body corporate, other than option contracts;[157] and knows or ought reasonably to know that the information is not generally available and that it might have a material effect on the price or value of those securities if it were generally available. It is a defence to an action for damages under s 1013 that a person has come into possession of information solely as a result of that information having been made known in a manner that would, or would be expected to, bring it to the attention of persons who commonly invest in securities of bodies corporate of a kind whose price or value might be affected by the information: s 1013(7).

If an insider contravenes s 1002G(2) by subscribing for or agreeing to subscribe for securities, or procures another person to subscribe for the securities, the issuer may bring an action under s 1005 to recover the amount by which the subscription price was less than the price at which the securities would have been likely to be sold in a sale at the time of the subscription, if the information had been generally available: s 1013(2). The measure of damages under s 1002G(2) may have anomalous results, since a negotiated subscription price would not necessarily correspond to the price at which shares were trading on market, or would have traded on market if material nonpublic information had been made available. An action under s 1002G(2) may be brought against the insider, the person whom the insider procured to subscribe for the securities, or a person involved in the contravention. It is not a defence to an action for damages brought by an issuer under s 1002(2) that the issuer possessed the relevant information at the time of the subscription. Section 1013(6) authorises the ASC to bring an action for damages under s 1002G(2) in the name of and for the benefit of the issuer of the securities, if it considers that it is in the public interest to do so.

If an insider contravenes s 1002G(2) by purchasing or agreeing to purchase securities from a person, or by procuring another person to purchase or agree to purchase securities, the seller may bring an action under s 1005 to recover the amount by which the price at which the securities were purchased, or agreed to be purchased, was less than the price at which they would have been likely to be purchased in a purchase at that time if the information had been generally available: s 1013(3). Such an action may only be brought if the seller did not

157 The Explanatory Memorandum to the *Corporations Legislation Amendment Act* 1991 notes that civil remedies for insider trading in respect of a subscription for option contracts are governed by s 1005, which deals with civil liability for contraventions of Part 7.11 and Part 7.12 of the *Corporations Law*. It notes that the recovery provisions under s 1013 would not be appropriate for the range of transactions associated with trading in option contracts.

possess the relevant information. If an insider contravenes s 1002G(2) by selling or agreeing to sell securities to a person, or by procuring another person to sell or agree to sell securities, the buyer may bring an action under s 1005 to recover the amount by which the price at which the securities were sold, or agreed to be sold, was less than the price at which they would have been likely to be sold in a sale at that time if the information had been generally available: s 1013(4). Such an action may only be brought if the buyer did not possess the relevant information.

Sections 1013(3) and 1013(4) may lead to fortuitous results when applied to transactions on the stock exchange, where the matching of buy and sell orders will have been random. To allow recovery to one or a small number of investors who, by chance, trade with the insider in a public market has little justification in principle. On the other hand, to allow damages to be recovered by all other persons who traded within the relevant period could lead to the insider being held liable for damages which are quite out of proportion to the scale of the insider's trading or to the profits he or she made. The concept of "proximity"[158] as a means of limiting the insider's liability, by analogy with the principles defining the duty of care in relation to negligence causing economic loss, may be no more satisfactory in this context. If such a notion were applied to assessing civil liability for insider trading, it would raise problems of lack of certainty and would leave the insider exposed to the possibility of liability substantially exceeding his or her profit.

One commentator has noted that any approach to the assessment of damages for insider trading must either limit the class of traders in a public market to whom the insider is liable, or place a ceiling upon his liability, or both.[159] If a ceiling is placed upon the insider's liability, then the class of investors suffering loss as a result of the insider's conduct must be defined in order to allow any damages to be apportioned between them. The American Courts have recognised this difficulty without resolving it in any consistent manner. In *Shapiro v Merrill Lynch, Pierce, Fenner & Smith Inc*[160] the Sixth Circuit was prepared to hold an insider liable for the losses suffered by all investors who bought or sold the relevant securities prior to disclosure of the information, whether or not they traded with the insider. On this approach, the insider's liability could exceed his or her profit on the transaction, possibly by a large margin. In *Fridrich v Bradford*[161] the Second Circuit recognised that the result in *Shapiro*[162] was extreme, and held that an insider was not liable to an investor

158 *San Sebastian Pty Limited v Minister Administering the Environmental Planning and Assessment Act* (1986-87) 162 CLR 340. The majority (Gibbs CJ, Mason, Wilson, Dawson JJ) there noted that '[t]he recovery of economic loss has traditionally excited an apprehension that it will give rise to indeterminate liability", and recognised the function of the proximity test as "limit[ing] the loss that would otherwise be recoverable if foreseeability were used as an exclusive criterion of the duty of care."

159 AJ Black note 1 *supra* at 664.

160 Note 41 *supra* at 239-241.

161 542 F 2d 307 at 318-319 (6th Cir 1976), cert denied 429 US 1053 (1977).

162 Note 41 *supra*.

whose transaction was well separated in time from the insider's trading, although it took place prior to public disclosure of the inside information.

In *Elkind v Liggett & Myers Inc*,[163] the Second Circuit held that each person who traded contemporaneously with an insider had an action for damages measured as the difference between the price at which that person purchased or sold and the price at which the purchase or sale would have occurred had the relevant information been disclosed to the market. However, the Court held that the total liability of a tipper was limited to the amount of profit made by his or her tippee; its reasoning suggesting that a similar restriction would have applied to the liability of an insider who traded in his or her own right. In *Wilson v Comtech Telecommunications Inc*,[164] the Court held that an insider's liability was limited to those who traded "contemporaneously" with the insider, and denied standing to recover damages to a person who had traded a month after the insider's trading but prior to the public release of the information. Similarly, in *Moss v Morgan Stanley Inc*,[165] the Court denied standing to persons who had traded in the market generally, rather than trading with the insider or under the influence of trading by the insider, on the ground that the defendants owed no duty to such persons. This issue has since been resolved by statute in the United States, since s 20A of the *Insider Trading and Securities Fraud Enforcement Act* 1988 allows damages to be recovered by persons who trade contemporaneously with an insider, in the same class of securities and on the opposite side of the market, up to the limit of the profit made or the loss avoided by the insider.

If an action could have been brought by the seller or buyer of securities under s 1013(3) and s 1013(4) respectively, the body corporate which is the issuer of the securities is entitled to recover damages in an action under s 1005. In the case of a purchase of or agreement to purchase securities, the body corporate may recover the amount by which the price at which the securities were purchased, or agreed to be purchased, was less than the price at which they would have been likely to be purchased at that time if the information had been generally available: s 1013(5)(a). In the case of a sale of or agreement to sell securities, the body corporate may recover the amount by which the price at which the securities were sold, or agreed to be sold, was less than the price at which they would have been likely to be sold at that time if the information had been generally available: s 1013(5)(b). An action under s 1013(5) may be brought against the insider, a person whom the insider procured to subscribe for the securities, or a person involved in the contravention. Since an action by the company under s 1013(5) may only be brought if an action could be brought by a seller or buyer under s 1013(3) or s 1013(4) respectively, the company has no action under s 1013(5) if the seller or buyer of the securities possessed the relevant information at the time of the transaction.

---

163 Note 80 *supra*.

164 648 F 2d 88 (2nd Cir 1981).

165 719 F 2d 5 (2nd Cir 1983).

The ability of the issuer of the securities to recover damages against an insider under s 1005, when combined with the ability of a seller or buyer of the securities to recover damages in the same measure under s 1013(3) or s 1013(4) respectively, has the result that an insider may be subject to liability for twice the amount of his or her gain. Even if no investor in privity with the insider brings proceedings under s 1013(3) or s 1013(4), the insider may still be held liable to the issuer under s 1013(5). Section 1013(6) authorises the ASC to bring an action for damages under s 1013(5) in the name of and for the benefit of the issuer of the securities, if it considers that it is in the public interest to do so.

XVIII. CONCLUSION

Professor Tomasic has argued that the Griffiths Committee Report and the Government response to that Report have "too readily succumbed to arguments which seem to be based upon a philosophy of minimal legislative intervention in [the securities] industry, an industry that for so long has been largely immune from effective regulatory intervention."[166] In the writer's view, that assessment of the reform of Australian insider trading legislation is unsustainable. The *Corporations Legislation Amendment Act* 1991 widened the scope of the insider trading provisions, and substantially increased the criminal and civil penalties for insider trading. It did so in the context of a legislative commitment to regulation of the securities industry which has existed at least since the time of the Rae Report, and of an increased commitment of regulatory resources to market surveillance and the prosecution of market offences.

166 R Tomasic "Insider Trading Law Reform in Australia" note 5 *supra* at 142.