The Australian insider trading regime: Workable or hopelessly complex?

Published in:
Company and Securities Law Journal

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The Australian insider trading regime: Workable or hopelessly complex?

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Journal Title: Company and Securities Law Journal

Author(s): Gill North [*]

Article Citation: 27 C&SLJ 310

Publication Year: 2009

Jurisdiction: Australia

ABSTRACT

The efficacy of the Australian insider trading regime is the subject of ongoing debate. Uncertainties as to the nature, ambit and enforcement of the insider trading provisions abound, and while some parties suggest the regime is workable, others find it hopelessly complex and untenable. The article suggests that the effectiveness of the insider trading regime on a stand-alone basis is inherently limited. The regime needs to operate as one limb of a balanced and integrated corporate disclosure framework in order to achieve its policy goals of economic efficiency and market fairness.

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Introduction

Introduction

Australia has had some form of insider trading regulation for more than 30 years. The current insider trading prohibition applies to trading, procuring trading, or communicating inside information that is materially price sensitive and not generally available to the market, unless an exception or defence applies. [1] Nevertheless, debates on insider trading activity and the efficacy of the insider trading regime continue to be highly charged. [2]

Some scholars and market practitioners suggest the issue of whether, and to what extent, insider trading regulation is required ought to be determined empirically. Empirical assessments of the net efficiency of insider trading regimes are very difficult to construct, and the nature of insider trading is such that it is not possible to ascertain the full extent of such conduct in a market. Nevertheless, empirical research provides useful pointers for policy-makers and other interested parties. The accumulated evidence generally supports a prohibition on insider trading activity on economic and fairness grounds.

Assuming acceptance of the economic and fairness benefits of an insider trading regime, the challenge is to find the most appropriate form of regulation to achieve these benefits. Unfortunately, there are no perfect or easy regulatory solutions. Drafting and enforcing insider trading provisions are complex tasks. It is difficult to establish rules that effectively capture intended insiders while excluding those who trade on the basis of public observations or on information ferreted out through independent research.

The article seeks to provide an overview of the main legislative, marketplace and enforcement issues relating to the insider trading regime in Australia to enable parties to better understand the ongoing policy debates. It suggests that the efficacy of the insider trading provisions depends on whether the regime

• provides sufficient certainty to all parties on what market conduct is prohibited;

• deters the behaviour that the policy-makers and legislators intend to prohibit; and

• ensures or enhances marketplace conduct in accordance with the policy goals of economic efficiency and market fairness. (2009) 27 C&SLJ 310 at 311

The response outlined in relation to the first test is generally negative. The nature and scope of the insider trading regime are uncertain. Rolfe J suggested in Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd (No. 2) (1996) 14 ACLC 1514 that the provisions require reconsideration. His Honour indicated (at 1522) that legislative provisions, which create serious criminal offences, ... should provide not only difficulties of interpretation because of the language used, but because of apparent internal inconsistencies. Mason P highlighted some of these uncertainties in R v Firns 38 ACSR 223, particularly the interpretative difficulties with the generally available carve-out. [3] Kirby J concluded that the question of what the insider trading prohibition is concerned with [and which] people and activities ... are to fall within it [4] is difficult to answer.

The picture provided in response to the second test is also ambiguous. Market practitioner feedback, recent media coverage, and a 2008 ASIC stakeholder survey reflect widespread negative views about the efficacy of the insider trading regime and its ability to deter market abuses. [5] Some of these negative views may be explained by misunderstandings or poorly informed views on what constitutes insider trading, the extent of illegal trading, and the level of successful enforcement.

Over the last 10 years, there have been around 16 successful individual insider trading actions in Australia. However,
the total amount of money involved was relatively insignificant. Moreover, the Securities Exchange Commission (SEC) in the United States, the Financial Services Authority (FSA) in the United Kingdom and global commentators suggest that the enforcement task is becoming more complex, with an increasing proportion of systemic professional insider trading activity. This trend makes it particularly difficult for regulators to piece together a successful insider trading case.

Australian policy-makers have acknowledged these uncertainties and difficulties. Since the late 1980s, the insider trading provisions have been subjected to a series of major policy reviews. The most recent was by the Corporations and Markets Advisory Committee (CAMAC) in 2003. This review examined two main issues:

- the extension of the insider trading prohibition in 2002 to cover all financial products as part of the financial services reforms;[7] and
- the published information and readily observable matter carve-outs within the insider trading provisions.

CAMAC considered three possible approaches to the application of the insider trading provisions in Australian financial markets:

- return the legislation to the pre-March 2002 position;[8]
- retain the existing law with specific defences or carve-outs where appropriate (the carve-outs approach); or

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- tighten the ambit of the legislation by focusing the prohibition on information that the market expects should be disclosed to all participants on an equal basis [and by introducing] ... a new simplified test of when information is generally available (the proposal).[9]

Some of CAMAC’s recommendations included majority and minority options.[10] The majority supported the proposal, while the minority opted for the carve-outs approach.[11] The majority proposed a new publishable information test to replace the existing published information and readily observable matter tests within the definition of generally available.[12] The minority preferred the current tests of when information is generally available to be retained, subject to modifications to the readily observable matter test.[13]

The government belatedly responded to the CAMAC recommendations with a Position and Consultation Paper (PCP) in 2007.[14] However, as yet no legislative changes have resulted, and it is unclear which, if any, of the CAMAC or PCP proposals will be implemented.

The article concludes that to be effective, the regime needs to operate as one limb of a balanced and integrated corporate disclosure framework. The extent to which an insider trading regime can achieve the policy goals of economic efficiency and market fairness operating on a stand-alone basis is inherently limited.

The next part of the article outlines empirical research on insider trading, followed by a summary of the insider trading provisions and the policy rationales supporting the regime. The CAMAC and PCP reviews of the insider trading provisions are then analysed, and the successful insider trading enforcement actions reviewed. The final part provides a conclusion.

Insider trading empirical research

Insider trading empirical research Some scholars and market practitioners suggest that the debate on whether insider trading regulation is justifiable and questions on the efficacy of insider trading enforcement ought to be determined empirically.[15] However, market complexities are such that it is not possible to conclusively prove the extent of insider trading or the net economic effect of insider trading or insider trading regulation. Empirical studies can generally only make credible inferences and these inferences need to be viewed within a specified context.

Insider trading studies are inevitably restricted in scope due to the inherent secrecy involved in such trading. Assessments of the net economic efficiency of insider trading regulation are therefore complex and difficult to construct in practice.[16] Potential measurements of market efficiency include (2009) 27 C&SLJ 310 at 313

- Potential measurements of market efficiency include

- the speed and accuracy of price adjustments to new information,[17] liquidity,[18] spreads,[19] volatility,[20] transaction costs,[21] and the inability to earn persistent abnormal returns. [22] However, all of these proxies are interrelated.[23]

The most compelling empirical evidence or inferences are those drawn from a wide range of studies using different measures, samples and designs, particularly when the evidence presents a relatively consistent picture. On this basis, the empirical research to date suggests a valid economic basis for insider trading regulation.

There are many studies examining whether private information held by corporate insiders enables abnormal returns
over the period studied compared to benchmark market returns. All of the outlined studies found that insiders were able to make abnormal gains or reduced losses. Seyhun found that corporate insiders, particularly chairpersons or officer directors, were able to make excess returns. [24] Similarly, Elliott, Morse and Richardson found that the direction of insider trading was consistent, with insiders using private information in a profitable manner. [25] Eyssell, and Seyhun and Bradley found that insiders, particularly top executives and officers, were involved in significant sale trades prior to bankruptcy filings, thereby avoiding significant capital losses based on non-public information. [26] Fidrmuc et al found that share ownership by directors and outside shareholders had an impact on the abnormal returns achieved by insiders. The abnormal returns made by directors as insiders were significantly lower when the company was controlled by other companies, individuals or families unrelated to the directors than when the dominant shareholders were institutional investors. [27]

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In Australia, Brown et al found evidence consistent with share sales by Australian directors resulting in avoidance of future abnormal losses, while director purchases yielded mixed results. [28] Watson and Young also found evidence of insider trading by Australian directors prior to takeover announcements. [29]

The next group of research suggests that the long-run impacts of allowing insider trading are a reduction in market liquidity and an increase in bid/ask spreads, two recognised measures of market efficiency. Cornell and Sirri found that short-term liquidity improved when insiders were active in the market prior to the announcement of a takeover bid due to higher trading volumes. [30] However, the market makers and insiders were able to exploit the uninformed in these cases, and Cornell and Sirri suggested that the likely long-run impact of such incidents is an increase in spreads. [31] Indeed, a model by Fishe and Robe found that insider trading has a negative impact on market liquidity because market makers adjust both depth and spread to compensate for the risk from informed traders. [32] Moreover, Masson and Madhavan suggested that insider trading lowers a firm's value. [33]

Another body of work examines selected variables across global securities markets. These studies have limitations because directional and endogeneity issues are difficult to control. Nevertheless, this research suggests that countries with insider trading laws have more liquid markets, more accurate pricing and a lower cost of capital. A study by Bhattacharya and Daouk suggested that countries that enforce their insider trading law have a significantly lower cost of capital. [34] Du and Wei suggested that countries with more prevalent insider trading have more volatile markets after controlling for the liquidity, maturity and fundamentals of the relevant markets, and the effect of insider trading is quantitatively significant when compared with the effect of economic fundamentals. [35] Similarly, Beny suggested that countries with insider trading laws generate positive market externalities; that is, such laws are associated with more liquid stock markets and more informative stock prices. This enhanced liquidity and price accuracy results in a reduced overall cost of equity and improves the efficiency of capital allocation. [36]

Finally, there is a significant and growing body of research that specifically examines the links between reductions in information asymmetry and public disclosure of company information with lower costs of capital. [37] One stream of this research links the reductions in information asymmetry (2009) 27 C&SLJ 310 at 315 and lower cost of equity capital with a reduction in investors' estimation risks. Another stream links reductions in information asymmetry and a lower cost of equity capital with reduced transaction costs or increased liquidity.

Botosan suggested that although the individual studies on cost of capital are not perfect, [38] the sum total of the accumulated evidence lends considerable support to the hypothesis that enhanced disclosure reduces cost of capital. [39] The bulk of this literature suggests that greater disclosure reduces the cost of equity capital. [40]

In summary, the studies generally find that corporate insiders can outperform market benchmarks by trading on private information. The research also suggests that countries or markets that establish and effectively enforce insider trading regulation achieve superior economic or efficiency outcomes in the form of lower costs of capital than markets that do not. This appears to arise, at least in part, from a reduction in information asymmetry. Notably, no scholarly research was found that suggests or infers that insider trading enhances net economic efficiency over the long run.

Insider trading provisions

Insider trading provisions provide for the protection of the public by prohibiting any person from acquiring or disposing of a financial product having inside information, procuring any person to acquire or dispose of a financial product having inside information, or communicating to any person the inside information which the person has acquired, whether or not that person has already acquired or disposes of a financial product having inside information or procuring any person to acquire or dispose of a financial product having inside information. The inside information which the person procuring or communicating has acquired is not generally available or is not generally available to the person. The inside information is material if the information is not generally available or if the information were generally available, a reasonable person would expect it to influence him or her in making a decision about the financial product which it relates to.
... financial products in deciding whether or not to acquire or dispose of the ... products. Information is generally available if

- it consists of readily observable matter (the readily observable matter test); or

- it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in ... financial products of a kind whose price might be affected by the information; and since it was made known, a reasonable period for it to be disseminated among such persons has elapsed (the published information test); or (2009) 27 C&SLJ 310 at 316

- it consists of deductions, conclusions or inferences made or drawn from readily observable matter or published information (the analysis test).

The terms readily observable matter, persons who commonly invest and reasonable period are not defined in the Act.

**Policy rationales supporting the australian insider trading regime**

Policy rationales supporting the australian insider trading regime Insider trading was first prohibited in Australia in 1970 when four States enacted a uniform Securities Industry Act. In New South Wales, the relevant provision was s 75A of the Securities Industry Act 1970 (NSW). When a cooperative companies and securities scheme was established in 1980, the main insider trading provision was s 128 of the Securities Industry Act 1980 (Cth). An insider trading offence under s 128 required a connection between the individual trading and the relevant company. This connection included a position as an officer of the company, or a professional or commercial relationship with the company.

The insider trading regime has undergone a series of major reviews since the late 1980s. The Anisman Report in 1986 highlighted that insider trading regulation is generally based on either fiduciary duty or informational advantage principles. It recommended that Australia adopt equality of access to information as the primary rationale for insider trading regulation. Similarly, in 1989 the Griffiths Committee concluded that use of information, rather than any connection between a person and a corporation, should be the basis for determining insider trading liability. The need to guarantee investor confidence in the integrity of the securities market was emphasised.

The legislators adopted the recommendations of the Anisman and Griffiths Committee reports. Section 1002G of the Corporations Law was enacted in 1991, significantly widening the definition of insider trading and removing the need to show a fiduciary link or a duty of care.

The 2001 CASAC Discussion Paper on insider trading indicated that the market fairness and market efficiency rationales are based on the use of inside information, while the fiduciary duty and misappropriation rationales only apply when the insider is in a fiduciary relationship with the relevant company or with the owner of the information. The CAMAC Insider Trading Report (2003), and the Insider Trading Position and Consultation Paper (March 2007) (PCP), indicated that market fairness and market efficiency are the primary rationales supporting insider trading regulation in Australia.

The CAMAC report and the PCP are outlined and discussed in the next part of the article. As yet, no legislative proposals or changes have resulted from these reviews.

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**Corporations and Markets Advisory Committee review and Position and Consultation Paper**

Corporations and Markets Advisory Committee review and Position and Consultation Paper

Corporations and Markets Advisory Committee review

The Corporations and Markets Advisory Committee (CAMAC) reviewed and reported on the insider trading regime in 2003. The Committee grappled with two main issues: the extension of the regime in 2002 to cover all financial products as part of the financial services reforms; and the published information and readily observable matter carve-outs within the insider trading provisions. CAMAC ultimately considered three possible approaches to the application of the insider trading provisions in Australian financial markets:

- return the legislation to the pre-March 2002 position; or

- retain the existing law with specific defences or carve-outs where appropriate (the carve-outs approach); or
tighten the ambit of the legislation by focusing the prohibition on information that the market expects should be disclosed to all participants on an equal basis [and by introducing] ... a new simplified test of when information is generally available (the proposal). [63]

Some of CAMAC's recommendations provide majority and minority options, including Recommendations 10 and 38 on the generally available tests. [64] The majority supported the proposal, while the minority opted for the carve-outs approach. [65]

The majority proposals

Published information test The majority argued that the published information test [66] can create considerable uncertainty about when persons may lawfully trade. [67] It can be difficult to determine [w]hen, or how, information can be 'made known' ... [or] how many investors are contemplated in the expression 'persons who commonly invest'. [68] They even rhetorically asked whether it would suffice if the information was known to a particular group of investors, such as a group of brokers, persons working on a confidential planned takeover bid or subscribers to a research newsletter. [69] The issue of what constitutes a reasonable period for dissemination of information is also open to interpretation.

The majority proposed a new publishable information test to replace the existing published information and readily observable matter tests within the definition of generally available. [70]

Readily observable matter test The CAMAC majority suggested that the ambit of the readily observable matter test [71] is even more uncertain than the published information test. [72] They argued that [2009] 27 C&SLJ 310 at 318

the focus of the insider trading prohibition should be on information that the market expects should be disclosed to all participants on an equal basis. To permit trading in these circumstances could give the informed persons an unfair advantage over other market participants and undermine confidence in the fairness and integrity of financial markets. [73]

The majority concluded that the insider trading prohibition should apply only to confidential price-sensitive information that should be generally disclosed [disclosable information] or will be the subject of a public announcement [announceable information]. [74] To achieve this goal, they recommended [75] that the phrase the inside information is disclosable information or announceable information; be added to s 1043A [76] and the following definitions of disclosable and announceable information be added to s 1042A:

**disclosable information** means information that:
(a) has to be disclosed either now or in the future pursuant to any legal or regulatory requirement (other than a requirement for disclosure only to a counterparty), whether or not that obligation is complied with, or
(b) would come within paragraph (a) were any person subject to the legal or regulatory requirement to be aware of the information, or
(c) would come within paragraph (a) or paragraph (b) if the subject matter of the information came to fruition (whether or not it does so);
**announceable information** means information, other than disclosable information, that
(a) will become the subject of a public announcement, or
(b) would come within paragraph (a) if the subject matter of the information came to fruition (whether or not it does so). [77]

The proposal also recommended that the current s 1042C(1) be replaced with the following provisions:

1042C(1) For the purposes of this Division, information is generally available only if it
(a) is accessible to most persons who commonly invest [78] in Division 3 financial products of a kind whose price or value might be affected by the information, or
(b) consists of deductions, conclusions or inferences made or drawn from any information referred to in paragraph (a).
Information is deemed to satisfy paragraph (1)(a) if it is disclosed pursuant to any prescribed disclosure procedure. [79]

Notably, the proposal directly linked the insider trading provisions with the continuous disclosure regime. [80]

In addition, the majority suggested that the list of prescribed disclosure procedures could be augmented over time, as communication technology develops or as different markets provide new methods of disseminating information to their participants. [81]

The majority concluded that the new test of generally available would overcome complexities and ambiguities in the current test (including the indeterminate breadth of the “readily observable matter” concept). [82] They further argued that the proposal would avoid an overreach of the prohibition to over-the-counter market trading and trading in the financial products of unlisted entities. [83]

The minority proposed that the current published information test should remain as it is. [84] Further, the readily observable matter test should remain subject to modifications that the relevant matter must be observable:

- by a cross-section of Australian investors
- without resort to technical assistance beyond that likely to be used by a cross-section of those investors, and
- for a reasonable period of time. [85]

The minority argued that the current approach to insider trading—a broadly expressed offence subject to particular carve-outs—is neither untenable nor unworkable. [86] They suggested that any problems facing over-the-counter or other markets can be dealt with on a case-by-case basis where the justification for a defence or carve-out is apparent. [87]

**Position and Consultation Paper**

Position and Consultation Paper The government belatedly responded to the CAMAC recommendations with a Position and Consultation Paper (PCP) in 2007. [88] The PCP indicated that the government accepted 31 of the 38 recommendations made by CAMAC. [89] Public submissions were sought on the remaining recommendations, including those on the statutory definitions of generally available and inside information.

The PCP rejected the CAMAC majority proposal on the following grounds:

- the proposed definitions of disclosable information and announceable information risk applying the insider trading provisions retrospectively; [90]

- the proposed definitions are not sufficiently clear or certain to justify being an element of a criminal offence; [91]

- [a]dding a further physical element for the prosecution to prove would make the prohibition more difficult to establish and enforce; [92] and (2009) 27 C&SLJ 310 at 320

- the proposed amendments do not pay sufficient regard to the importance of financial market transparency and to the expectations of the wider financial industry and community’s expectations as to what constitutes inside information. [93]

It concluded that the majority recommendation would increase the complexity of the insider trading provisions, resulting in greater uncertainty for market participants. [94] The PCP sought public comment on the following options to address the readily observable matter test uncertainties: [95]

1. Amend the readily observable matter test in accordance with the recommendation made by the minority of CAMAC; namely, the definition of generally available information continues to include the published information and readily observable matter tests. However, under the readily observable matter test, matters must be observable by a cross-section of Australian investors; in a manner that is likely to be observable within the resources of these investors; and for a reasonable period of time.
Readily observable matter test

The proposal by the CAMAC majority is compelling and deserves serious consideration. The underlying rationales for the proposal are sound. A person who possesses potentially publicly disclosable or announceable information is prohibited from trading, regardless of whether this information subsequently crystallises and is in fact disclosed or announced to the market. The definitions of announceable and disclosable information link the insider trading provisions with the continuous disclosure obligations by the inclusion of the ASX notification test.

In turn, the ASX notification requirement provides an unambiguously reliable and credible platform for all investors to reference in order to make informed investment decisions. Unfortunately, no published responses to the criticisms made of the proposal in the PCP could be found. It is not clear whether the government has definitively rejected this option as suggested by the PCP, or whether discussion on the proposal is still ongoing. The author wonders whether it is worth reconsidering the proposal as a civil regime provision. This might satisfy the critics whose primary argument appears to be the inappropriateness of a potentially retrospective criminal offence.

The first option proposed in the PCP raises some possible red flags. Although the rationales underlying the inclusion of the phrases cross-section of investors, in a manner that is likely to be observable within the resources of these investors and for a reasonable period of time are commendable, their inclusion within the readily observable matter carve-out may create more uncertainties than they resolve. Some parties may argue that this proposal would catch a person who

trades after viewing a factory fire or excess stocks in a yard, or following the discovery of minerals while flying over land.

Readily observable matter test

If not, this proposal may result in unnecessary detriment to many investors.

CAMAC and PCP critique

CAMAC and PCP critique

Published information test

The PCP accepted the existing published information test, suggesting the ambiguities and uncertainties highlighted in Firns and by the CAMAC majority are likely to remain. The changes proposed by the majority to the published information test are discussed within the readily observable matter section below.

A person can trade on information in the public arena, within or outside Australia, but not if it infringes rights of privacy, property or confidentiality; even if other market users cannot obtain it because of limitations on their resources, expertise or competence or only on payment of a fee; and even if it is only available overseas.

It is unclear which, if any, of the CAMAC or PCP proposals will be implemented by the current government.
Materiality and Interpretation or application of the generally available and materiality tests overlap. However, materiality issues are not discussed in the CAMAC or PCP reviews.

Links between the insider trading and continuous disclosure regimes. The CAMAC majority proposal reflects the links between the insider trading and continuous disclosure regimes. The author endorses this approach, and suggests that linking the two regimes is critically important for an effective corporate disclosure framework. However, the precise relationship between the regimes is presently unclear.

Academics generally suggest that the insider trading and continuous disclosure regimes are linked to some extent. Both the insider trading and continuous disclosure provisions require that the relevant information has a material effect on price and is not generally available. Further, one of the stated rationales for the introduction of continuous disclosure regulation is to minimise the opportunities for perpetrating insider trading or similar market abuses. Lindgren J confirmed in Australian Securities and Investments Commission v Southcorp Ltd (No 2) (2003) 130 FCR 406 at 408 that the continuous disclosure provisions are intended ... to prevent selective disclosure of market sensitive information.

However, Mason P indicated in R v Firns 38 ACSR 223 that while the possible alignment between the criminal regulation of insider trading activities and the continuous disclosure obligations might be a worthy suggestion or goal, this needs to be considered by legislators and not the judiciary. His Honour indicated (at 235) that as it stands currently, Division 2A and its criminal sanctions do not link themselves with the scheme of statutory reinforcement of ASX’s continuous disclosure rules.

Enforcement of Australian insider trading regulation

Enforcement of Australian insider trading regulation

Public views

Public views: Market practitioner feedback, recent media coverage, and a 2008 ASIC stakeholder survey reflect widespread negative views about the efficacy of the insider trading regime. Morgan, the investment director of 452 Capital and a well-respected fund manager in Australia, suggested that questionable trading prior to announcements from large companies is out of control. Sisson, the managing director of Balanced Equity Management Pty Ltd agreed, indicating that again and again you see price movements that are unexplained.

Similarly, Hunt, the chairman of Caliburn, suggested that share price movements prior to the public announcement of takeover bids and capital raisings are commonplace. He argued that the incidence of insider trading is unacceptably high and a change in regulatory approach is required.

Seabrook, an executive director of Gresham Investment Partners, suggested there are some outrageous practices at the larger end of the market where leaks occur. Moreover, in the 2008 ASIC stakeholder survey, only 39% of the business respondents and 7% of the consumer respondents were confident that Australian capital markets are free from insider trading and other market abuses, and only 30% agreed that fraud, dishonesty and misconduct are likely to be found and punished. Yet around 80% of the respondents agreed that prosecuting market abuses should be a high priority for ASIC.

Successful insider trading actions

Successful insider trading actions: Legislation can be 'misleading where its 'bark' is not co-extensive with its bite'. ASIC has initiated 13 successful insider trading cases since the beginning of 2002. This record of approximately two successful actions a year is higher than the levels achieved in the 1980s and 1990s.

Of the 13 successful cases since 2002, seven involved insider trading on non-public information concerning a proposed takeover, merger or alliance (Panchal, Petsas, Miot, Frawley, Rivkin, Hannes, and Doff), four involved trading on company earnings information prior to its official release (McKay, Hall, Sweetman and Reddell), one involved trading on private information about a gold mine project (Woodland), and one related to insider trading by a company director prior to liquidation (MacDermott). Of the four earnings-related cases, one involved a media relations consultant trading prior to a major announcement (McKay), two involved directors trading prior to the announcement of an earnings downgrade (Hall and Sweetman), and one involved a research analyst trading on earnings news prior to its public release (Reddell).

The only successful insider trading action initiated by ASIC under the civil penalty provisions is Australian Securities and Investments Commission v Petsas (2005) 23 ACLC 269. This case involved a client relationship manager at a bank passing on confidential information to a client about a pending corporate merger. The defendants, Petsas and Miot, admitted they had contravened the insider trading provisions and were ordered to pay pecuniary penalties and compensation of the profits made. It is not clear why civil penalties were sought in this particular case.
Civil penalties were also sought in Australian Securities and Investments Commission v Vizard (2005) 145 FCR 57; 54 ACSR 394 for improper use of information acquired by Vizard as an officer of a corporation. This approach was widely criticised, with many parties suggesting that Vizard got off too lightly in comparison with others convicted of insider trading under criminal sanctions. However, ASIC responded that there was insufficient evidence for a criminal prosecution, and if it had proceeded with a criminal action and failed, the civil penalty alternative would not then have been available.

Enforcement critique

Enforcement critiqueInsider trading enforcement difficulties arise on a global basis. Piecing together an insider trading case can be a complex and painstaking process. The SEC and the FSA point out that most insiders take care to cover their tracks and cases must often be built on circumstantial inferences of suspected misconduct. The SEC highlights that building an insider trading case based on circumstantial evidence can be frustrating, risky and time-consuming. The FSA indicates that the two most common reasons for closing insider trading investigations are (i) the absence of evidence of links between the dealer and any insiders and (ii) the absence of evidence of the passage of inside information.

Obtaining the evidence to establish the required elements for an insider trading action in Australia is also difficult. ASIC has to make prosecution choices with significant uncertainty around the nature and scope of the insider trading provisions and these uncertainties leave ASIC significantly handicapped in relation to effective enforcement of the regime. ASIC must decide whether to restrict actions to circumstances that fall within the more certain areas of the provisions or to proceed with test cases even when the probability of success is uncertain. On the one hand, ASIC is criticised for a policy based on achieving a high litigation success rate. Such a policy is an efficient use of taxpayer funds, but inevitably this approach results in a failure to prosecute cases with less certain outcomes. However, ASIC is also criticised for taking actions that fail. For example, the case brought by ASIC against Citigroup was questioned by a number of commentators. Some parties criticised ASIC simply because the action failed, while others questioned the ASIC rationales for initiating this particular test case.

Some commentators describe the insider trading provisions in Australia as broad within the global context. However, arguably most, if not all, of the outlined insider trading charges would also have succeeded in the United States under the fiduciary duty or misappropriation insider trading liability categories, that is, trading by corporate insiders under a fiduciary duty or tippees thereof, or trading by outsiders who obtained their information through breaches of fiduciary duty or confidentiality with the relevant companies.

Panchal, MacDermott, Hall, Sweetman and Vizard traded on inside information as company directors. Woodland traded on information passed to him from the company chairman. Miot was a direct tippee of Petsas. Doff and Rivkin were tippees of McGowan, who was a director of Impulse. McGowan advised both Cisco, which had an existing business relationship with the company whose shares were traded, and the information traded on was subject to a strict confidentiality agreement. Finally, Reddell traded on information about an earnings downgrade while employed as an equity research analyst.

Conclusion

The primary rationales supporting the insider trading prohibition and the broader corporate disclosure framework in Australia are economic efficiency and market fairness. While it is difficult to theoretically or empirically ascertain the net economic efficiency of insider trading rules within complex securities markets, the outlined empirical research suggests a sound economic basis for insider trading regulation. Beny suggested that adequately enforced insider trading laws are associated with enhanced liquidity, more informative stock prices, lower costs of capital, and improved capital allocation efficiency. Bhattacharya and Daouk suggested that countries that enforce their insider trading law have a significantly lower cost of capital. They highlighted that though the debate about the pros and cons of allowing insider trading in stock markets has been quite contentious in the law, economics and finance literature, practice, the debate seems to have been settled.

By the end of 1998, all of the 22 developed countries and four out of five of the 81 emerging markets had insider trading laws in their books.
However, laws are generally only effective when they are enforced on a consistent and fair basis, when they are seen to be enforced as such, and when the nature and level of enforcement action is appropriate to the misconduct or crime involved or to the likely market deterrent effect. Ultimately, the efficacy of the Australian insider trading regime depends on whether the regime

- provides sufficient certainty to all parties on what market conduct is prohibited;
- deters the behaviour that the policy-makers and legislators intended to prohibit; and
- ensures or enhances marketplace conduct in accordance with the policy goals of economic efficiency and market fairness.

**Is there sufficient certainty on what market conduct is prohibited under the regime?**

Is there sufficient certainty on what market conduct is prohibited under the regime? The CAMAC majority suggested that the breadth of the existing generally available tests is uncertain. In addition, some of the Australian judiciary have indicated that the current insider trading provisions do not provide sufficient certainty on what conduct is prohibited and requires reconsideration. However, there are no easy or perfect drafting solutions. All of the outlined CAMAC and PCP proposals raise some issues.

**Does the regime deter the behaviour that policy-makers intended to prohibit?**

Does the regime deter the behaviour that policy-makers intended to prohibit? Whether the current level of insider trading enforcement is appropriate or effective depends upon one's view of the level of insider trading occurring. This view depends in turn on one's interpretation of what constitutes insider trading. A majority of the respondents of a recent ASIC-sponsored survey, including both business representatives and consumers, and leading market participants such as Morgan and Hunt, suggested that many, if not most, Australian insiders are not deterred under the current regime and do not face any regulatory action. Hunt suggested that people within the marketplace know, as much as you can possibly know, that insider trading is taking place. While the actual level of insider trading in Australia is unknowable, a perception by a large proportion of market participants that there is rampant unenforced insider trading or other market abuses is likely to have a significant impact on investor confidence, regardless of the accuracy of the perception.

In practice, the nature of, and difficulties with, insider trading enforcement are such that actions in Australia are generally only taken against a small number of individuals, and arguably these incidents are not representative of most insider trading activity. The amount of profits or reduced losses from the [2009] 27 C&SLJ 310 at 327 13 successful actions since 2002 total approximately $3,700,000, with $2,000,000 of this gained in the Hannes case. It is likely that these enforcement actions represent only the tip of the iceberg in terms of insider trading occurrences. The SEC, the FSA, a prior head of enforcement at the London Stock Exchange, and commentators have all suggested that the most significant insider trading problems and losses arise from systemic professional insider trading on either a transactional or longer-term basis. The SEC highlighted that individuals engaged in misconduct are increasingly securities professionals, gatekeepers or high ranking corporate officials. Recidivist insider trading cases and serial illegal trading have become more common. In such cases, insider trading can be carried out by a number of defendants, involving multiple trades over a number of months, using sophisticated approaches. Professional insiders are smart and always look for new ways to gain an edge, particularly when there are huge chunks of precious valuable information.

**Is the regime achieving its policy goals of economic efficiency and market fairness?**

Is the regime achieving its policy goals of economic efficiency and market fairness? Arguably, limited resources are best allocated to company disclosure issues with the most significant impact on investors, market conduct, and achievement of the regulatory goals. In practice, most cases of insider trading or selective disclosure in Australia arise when companies fail to comply with their periodic and continuous disclosure obligations. Moreover, a failure by companies to periodically or continuously disclose, or selective disclosure by companies to a small group of investors, generally affects a significant proportion of the investors in the relevant company. This suggests that to be effective, the Australian insider trading regime needs to operate as one limb of a balanced and integrated corporate disclosure framework.
Footnotes

1 BComm, ACA (NZ); ASIA exams, SIE (Dip) (UK); DipFS(FP), LLB (Hons) (Aust). Currently a doctoral researcher in law at the University of New South Wales. The author thanks Professor Buckley, Martin North and the anonymous referee for their insightful feedback.

2 Corporations Act 2001 (Cth), Div 3 of Pt 7.10.

3 See eg Allen Consulting Group, ASIC Stakeholder Survey (April 2008); Australian Broadcasting Corporation, "Heat on Regulators over Insider Trading Allegations", 7.30 Report (ABC, 16 April 2008) (ABC). It would be very interesting to know how many Australian policy-makers, regulators, corporate law lecturers, legal practitioners and financial managers feel confident explaining the nature and scope of the current insider trading prohibition to their constituents, students, clients and employees respectively, or alternatively, how many think the provisions are hopelessly complex or untenable.


7 See below n 115 for relevant case or ASIC media release details. Some of these cases were against market professionals. However, none involved tippees beyond one level from the direct source or systemic insider trading.

8 CAMAC Report, n 3, pp i-iii. Until March 2002, the insider trading prohibition was confined to transactions in securities (whether of public or private entities), interests in managed investment schemes and futures contracts that related to the securities of a body corporate or the price of these securities. However, the prohibition was extended as part of the Financial Services Reform Act 2001 (Cth). The financial products now covered by the prohibition include securities, including options over unissued shares; derivatives; interests in a managed investment scheme; debentures, stocks or bonds issued or proposed to be issued by a government; superannuation products (other than prescribed products); or any other financial products that are able to be traded on a financial market.

9 CAMAC Report, n 3, p 47.

10 CAMAC Report, n 3, p 47.

11 CAMAC Report, n 3, p 13. The minority comprised D Knott, the prior Chairman of ASIC, and in some instances another committee member. The majority recommendations were supported by the remaining 12 or 13 members of the committee as outlined on pp vi and vii of the report.

12 CAMAC Report, n 3, p 47.


24 Seyhun H, "Insider's Profits, Costs of Trading and Market Efficiency" (1986) 16 J Finan Econ 189 at 210;


Cornell and Sirri, n 30 at 1055.


Du J and Wei S, "Does Insider Trading Raise Market Volatility?" (2004) 114 Econ J 916 at 916, 940. Du and Wei point out that a certain degree of market volatility is unavoidable; however, excessive volatility not related to economic fundamentals diminishes the signalling function and impedes resource allocation.


Botosan, n 37 at 31-33. See also Cooper, n 37 at 41. Various proxies have been used to date to measure cost of capital and improved levels or quality of disclosure. However, all of these measures have flaws that are difficult to fully resolve.

Botosan, n 37 at 39.

Botosan, n 37 at 31.

Corporations Act 2001 (Cth), s 1043A(1)(c).

Corporations Act 2001 (Cth), s 1043A(1)(d). Procure is defined in s 9 of the Corporations Act 2001 (Cth) to include cause. Similarly, s 1042F(1) provides that to procure means that a person incites, or encourages an act or omission by another person.

Corporations Act 2001 (Cth), s 1043A(2). The communication offence is generally referred to as the tipping offence. No association is required between the tipper and the tippee. There are differences between the three offences. For example, the tipping offence only applies to products traded on a financial market, while the trading offences are broader.

Corporations Act 2001 (Cth), ss 1043B-1043D.

Section 1043A has been in effect from 11 March 2002.

Corporations Act 2001 (Cth), s 1042A.

Corporations Act 2001 (Cth), s 1042D.

Corporations Act 2001 (Cth), s 1042C(1)(a).

Corporations Act 2001 (Cth), s 1042C(1)(b).

Corporations Act 2001 (Cth), s 1042C(1)(c).


Anisman, n 51, p 13.

Commonwealth, House of Representatives Standing Committee on Legal and Constitutional Affairs, Fair Shares for All: Insider Trading in Australia (October 1989) at [3.3.5], [4.3.5] (Griffiths Report).

Griffiths Report, n 53 at [3.3.4]. The Committee rejected the notion that insider trading promotes market efficiency or that it is a legitimate reward for enterprise. Enacted under the Corporate Law Reform Act 1991 (Cth). The Explanatory Memorandum stated that it was necessary to control insider trading to protect investors and make it attractive for them to provide funds to the issuers of securities, for the more efficient development of Australia's resources.

See Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd (No 2) (1996) 14 ACLC 1514 at 1519, 1522. Section 1043A, the main insider trading provision currently, is broadly the same as s 1002G.


CASAC, n 57, p 13.

CASAC, n 57, pp 13-14.

CAMAC Report, n 3, p ii; Commonwealth of Australia, n 14, p v.
The majority suggested (p 52) that a note in the Explanatory Memorandum or in legislation could:

- state that information satisfies paragraph (1)(a) only if it either can at that time be obtained by most investors without resort to technical assistance beyond that likely to be used by those investors or comes within subsection (1A);

- list examples of information that satisfies paragraph (1)(a), including, for instance, any information that has been published in widely circulated print or broadcast media;

- indicate that posting information on the Internet will not make the information accessible under paragraph (1)(a) unless the information has been disclosed through a prescribed Internet disclosure procedure under subsection (1A).
See North, n 99 for discussion on materiality issues.


Corporations Act 2001 (Cth), ss 674(2)(c)(ii), 677, 1042A, 1042D.

Corporations Act 2001 (Cth), ss 674(2)(c)(i), 676, 1042C, 1043A; R v Hannes (2000) 158 FLR 359 at 402-408 (Spigelman CJ); R v Frawley 38 ACSR 223 at 235-238 (Mason P).


Allen Consulting Group, n 2, pp 13, 14, 30; ABC, n 2, ASIC, n 5.


See also ABC, n 2.

ASIC, n 5, p 83.


See also ABC, n 2.

West, n 110. See also ASIC, n 5, pp 77-88.

ASIC, n 5, p 82.

Allen Consulting Group, n 2, pp 13, 14, 19, 30, 35.

Semaan et al, n 103 at 235.


Thomson, n 127.
Financial Services Authority (FSA), Market Watch, Issue 26 (April 2008) pp 6-7. From March 2009, companies in the United Kingdom have been required to record all telephone communications and electronic communications relating to client orders and the conclusion of transactions in the equity, bond and derivatives markets.


Wilson S, "ASIC a Puppy in Need of Bite", The Australian (Sydney) (18 October 2005) p 22; Bolt, n 126.


Insider trading liability in the United States generally arises under r 10b-5. Rule 10b-5, which was promulgated by the SEC under s 10(b) of the Securities Exchange Act 1934 (US), is a broad provision directed at fraudulent practices. This rule distinguishes insider trading based on the source of an information advantage and the presence of a fiduciary duty. Insiders who trade based on non-public material information obtained from the traded firm may be liable to insider trading. Outsider traders who obtain their information through a breach of fiduciary duty may also be liable under the misappropriation theory of insider trading.

The detailed facts of this case are not available.

Beny, n 15 at 280-281. See also Du and Wei, n 35 at 916, 940 and the empirical research outlined above at 312-315.

Bhattacharya and Daouk, n 34 at 36. Bhattacharya and Daouk indicate (at 75) that prior to 1990, only 34 countries had insider trading laws and only 9 of these had any record of enforcement. However, by 2000, 87 of the 103 countries with stock markets had laws prohibiting insider trading and 38 had taken enforcement action.

ASIC, n 5, p 82.

Panchal: estimated profit $322,155; Petas and Miot: combined profit $128,495; Frawley: profit $586,001; Rivkin: profit $2,665; Hannes: profit $2,000,000; Doff: profit $11,400; Hall: reduced loss $212,532; Sweetman: reduced loss $270,400; McDermott: profit $10,116; McKay: profit $70,000; Reddel: proceeds $41,132; Woodland: estimated profit $27,000. In the United States, the SEC brought 300 insider trading actions against more than 600 individuals and entities involving millions of dollars between 2001 and 2006. During 2007, the SEC successfully initiated 47 insider trading cases involving 110 defendants and approximately US$150 million in profits: Thomsen, n 127; Thomsen L, SEC, Opening Remarks to the Securities Industry and Financial Markets Association Regulatory Symposium on Insider Trading (19 May 2008).


ASIC, n 5, p 90; Cole, n 127; Rider, n 145, p 73; Thomsen, n 127; Thomsen, n 144.

Thomsen, n 144. The SEC sued a number of lawyers during 2007 for insider trading.

Thomsen, n 144.

Cole, n 127; Thomsen, n 144.

ASIC, n 5, p 97. See also Thomsen, n 144.

ASIC, n 5, p 95.

Gething, n 96 at 620.

See Cole, n 127; Langevoort, n 137 at 1326-1327.