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BACK TO THE FUTURE? THE IMPACT OF FINANCIAL SERVICES REFORM ON INSIDER TRADING IN AUSTRALIA

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The most recent set of legislative amendments made to Australian insider trading laws resulted from the reforms contained in the Financial Services Reform Act 2001 (Cth). Those insider trading reforms included changes to the nature of the relevant financial products; changes to the type of prohibited conduct; and changes to the potential consequences for breaching the prohibition on insider trading. This paper will examine in detail the reforms made to the law of insider trading, consider their effect to date on insider trading in Australia, and identify remaining gaps and inconsistencies in the law which are yet to be effectively addressed.

1 INTRODUCTION

The *Financial Services Reform Act* 2001 (Cth)[1] had a lengthy genesis. The process commenced in June 1996, with the Financial Services Inquiry chaired by Mr Stan Wallis – various reforms concerning the financial services industry were suggested by the 'Wallis Inquiry'. Then, in December 1997, the Corporate Law Economic Reform Program's sixth policy paper was released – it was titled 'Financial Markets and Investment Products: Promoting Competition, Financial Innovation and Investment' and became known as 'CLERP 6'. Following the receipt of submissions on the CLERP 6 policy paper, the CLERP Consultation Paper 'Financial Products, Service Providers and Markets – An Integrated Framework' was released on 3 March 1999. This led to the preparation and release of the first exposure draft bill and accompanying commentary in February 2000, which eventually gave rise to the *FSR Act* itself. As stated in the Explanatory Memorandum, the purpose of the various reforms was to:

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[1] To be referred to from now as on as the '*FSR Act'*.

> … put in place a competitively neutral regulatory system which benefits participants in the industry by providing more uniform regulation, reducing administrative and compliance costs, and removing unnecessary distinctions between products … to give consumers a more consistent framework of consumer protection in which to make their financial decisions … [and] to facilitate innovation and promote business, while at the same time ensuring adequate levels of consumer protection and market integrity.[2]

The *FSR Act* came into effect on 11 March 2002, with a gradual implementation over a two year period. Thus the *FSR Act* amendments have now been in full effect for more than three years.

Although the *FSR Act* has made many significant changes to the financial services industry, this paper will focus on its impact on the laws regulating insider trading. In essence, insider trading occurs when a person trades in financial products whilst in possession of price-sensitive information which is not publicly available. The elements of the insider trading offence can broadly be summarised as follows:

1. a person possesses certain information;

2. the information is not generally available;

3. the person knows (or ought reasonably to know) that the information is not generally available;

4. if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of financial products;

5. the person knows (or ought reasonably to know) that if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of those financial products; and

6. whilst in possession of the information, the person trades in those financial products (that is, buys or sells those financial products) or procures another person to do so.

This paper will first describe each of the reforms made to insider trading laws by the *FSR Act.* The effect of those reforms on insider trading in Australia will then be analysed in detail. This paper will highlight remaining insider trading issues which have not yet been effectively dealt with, and will conclude with a comment on likely future developments.

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2 Explanatory Memorandum, Financial Services Reform Bill 2001 (Cth) - to be referred to from now on as the '*FSR Bill*' - [1.5].

II NATURE OF *FSR ACT* INSIDER TRADING REFORMS

Amongst other significant amendments, the *FSR Act* amended the *Corporations Act* 2001 (Cth)[3] by repealing the old Division 2A Part 7.11 which was entitled 'Insider Trading'[4] and inserting a new Part 7.10, Division 3 into Chapter 7 of the *Corporations Act*.[5] Three major reforms relating to insider trading arose from these amendments:

1 the prohibition on insider trading was extended to apply to all 'Division 3 financial products', not merely securities;

2 the type of conduct prohibited by insider trading laws was widened; and

3 civil penalty proceedings became available for use against alleged insider traders.

Thus it can be seen that the *FSR Act* amendments to insider trading changed the *nature* of the financial products subject to the prohibition, changed the *type* of conduct caught by the prohibition, and changed the potential *consequences* for breaching the prohibition.

A *Extension of Insider Trading Prohibition to all Division 3 Financial Products*

The *FSR Act* changed the nature of the relevant financial products caught by the insider trading prohibition. Prior to the implementation of the *FSR Act*, insider trading was prohibited in relation to 'securities.' The old s 1002A of the *Corporations Act* provided that:

> 'securities', in relation to a body corporate, means any of the following:
> (a) shares in the body corporate;
> (b) debentures (including convertible notes) issued by the body corporate;
> (c) interests in a managed investment scheme made available by the body corporate;
> (d) units of shares referred to in paragraph (a);
> (e) an option contract under which a party acquires from another party an option or right, exercisable at or before a specified time, to buy from, or sell to, that other party a number of securities of a kind referred to in paragraph (a), (b), (c) or (d) at a price specified in, or to be determined in accordance with, the contract;
> but does not include a futures contract or an excluded security.

Insider trading now applies to all 'Division 3 financial products', which are defined under s 1042A of the *Corporations Act* as:

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[3] To be referred to from now on as the '*Corporations Act*'.
[4] Previously *Corporations Act* ss 1002-1002U.
[5] Part 7.10 Division 3 includes *Corporations Act* ss 1042A-1044.

(a) securities; or
(b) derivatives; or
(c) interests in a managed investment scheme; or
(ca) debentures, stocks or bonds issued or proposed to be issued by a government; or
(d) superannuation products, other than those prescribed by regulations made for the purposes of this paragraph; or
(e) any other financial products that are able to be traded on a financial market.

Thus certain 'products' which were not previously subject to insider trading laws have now been brought within the ambit of the prohibition. The reasoning behind this reform was the desire to ensure that conduct which amounts to an offence in relation to certain financial products should not, from a policy perspective, be permissible in relation to other financial products – especially given the aim of the FSR Bill to regulate 'functionally similar' financial products in a similar manner.[6] All financial products that are tradable on a market (and some which are not) are now subject to the prohibition on insider trading.

B *Widening of Type of Conduct Caught by the Insider Trading Prohibition*

The *FSR Act* changed the type of conduct prohibited by insider trading laws. The old 1002G (2) of the *Corporations Act* previously provided that a person in possession of 'inside information' must not:

(a) subscribe for, purchase or sell, or enter into an agreement to subscribe for, purchase or sell, any such securities; or
(b) procure another person to subscribe for, purchase or sell, or to enter into an agreement to subscribe for, purchase or sell, any such securities.

Since the implementation of the *FSR Act*, the new s 1043A(1) of the *Corporations Act* now provides that the 'insider' must not:

(a) apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products; or
(b) procure another person to apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.

Interestingly, there is no commentary in the Explanatory Memorandum explaining the motivation behind the decision to change the description of the prohibited conduct. It is now prohibited to 'acquire or dispose' of the relevant financial products, rather than just 'purchase or sell' them – although it is difficult to consider this as anything other than just the substitution of alternative synonyms. However, it is also prohibited to 'apply for' rather than merely 'subscribe for' such products

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6 Explanatory Memorandum, *FSR Bill*, [2.76].

and, as previously, it is prohibited to enter into an agreement to do any of these acts as well.

The phrase 'apply for' is broader in construction than its predecessor 'subscribe for' and should therefore encompass a greater scope of conduct. 'Applying for' securities would encompass a subscription for securities, but not necessarily vice versa. The term 'apply for' also arguably includes the making of offers and the entry of a bid offer on SEATS[7] for the purchase of securities,[8] and would therefore now avoid an outcome such as that in *R v Evans & Doyle*.[9]

In that case, Mr Evans (a director of MPI Ltd, an unlisted mining company) became aware of the discovery of certain mineral deposits near property owned by Mt Kersey NL, a listed mining company. MPI Ltd planned to issue a media release about the discovery of the mineral deposits on 20 November 1995. Mr Evans telephoned Mr Doyle, a stockbroker, and instructed him to buy shares in Mt Kersey NL on his behalf at the time he expected the media announcement to be released. Mr Doyle immediately placed the order on SEATS and, as a result, approximately 100,000 shares were later purchased for Mr Evans. Unknown to either party, the planned media release did not occur until later in the day. Both Mr Evans and Mr Doyle were prosecuted for insider trading. In an unfortunate drafting error, the prosecution had prepared the relevant particulars of the indictment so that the only acts complained of were those of the client placing the call to the broker and the broker placing the buy order on SEATS.

His Honour, McDonald J, determined that, in accordance with the construction of the old s1002G(2) of the *Corporations Act*, neither act constituted the subscription for securities, the purchase of securities, or an agreement to subscribe for or purchase securities, and therefore that the offence of insider trading could not be made out. As a result, the jury was instructed to return a verdict of 'not guilty'. McDonald J stated that the act of instructing a broker to purchase securities does not amount to 'an agreement to purchase … securities and only amounts to an agency agreement between the broker and instructing client.[10] Accordingly, he found that there is no agreement to purchase securities until the broker concludes an agreement with a selling broker on behalf of his or her client. Although there was a later concluded agreement, this did not fall within the ambit of the indictment.[11]

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7 The Stock Exchange Automated Trading System, which facilitates online trading.

8 Simon Rubenstein, 'The Regulation and Prosecution of Insider Trading in Australia: Towards Civil Penalty Sanctions for Insider Trading' (2002) 20 *Company and Securities Law Journal* 89, 111.

9 *R v Evans & Doyle* [1999] VSC 488 (15 November 1999), to be referred to from now on as the '*Evans and Doyle case'*.

10 The *Evans and Doyle case* [51].

11 Interestingly, a later application to amend the particulars of the indictment was refused: *R v Evans & Doyle* [1999] VSC 489 (16 November 1999).

Whilst ordinarily the placing of a buy order on SEATS will ultimately lead to the purchase of securities, which would then fall within the type of conduct which is prohibited, the intention and attempt to purchase is arguably also objectionable, especially if that is the act which occurs at the time when inside information is possessed.

C *Introduction of Civil Penalty Proceedings for Insider Trading*

The *FSR Act* altered the potential consequences for persons found to have breached the insider trading prohibition. This was done by extending the operation of the *Corporations Act* civil penalty regime[12] to insider trading, as well as to other forms of market misconduct.

The civil penalty regime operates as follows:

1. civil, not criminal, rules of evidence and procedure apply to the relevant proceedings[13] (although it has been stated that the meaning of the words 'civil evidence and procedure rules' is unclear);[14] and

2. matters must be established to the civil standard of proof only – that is, on the balance of probabilities – rather than to the criminal standard – that is, beyond all reasonable doubt.[15]

Thus, many of the 'vagaries' of a criminal trial can be avoided.[16]

This gives the ASIC the option of proceeding with civil penalty proceedings itself, rather than needing to refer the matter to the Department of Public Prosecutions for a criminal prosecution.

If civil penalty proceedings are successful, the potential consequences for a person found liable for insider trading are:

1. a pecuniary penalty – that is, a fine – of up to $200,000 for an individual or up to $1,000,000 for a corporation;[17]

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12 The civil penalty regime was first introduced by the *Corporate Law Reform Act* 1992 (Cth) and took effect on 1 February 1993.

13 *Corporations Act* s 1317L.

14 Tom Middleton, 'The Difficulties of Applying Civil Evidence and Procedure Rules in ASIC's Civil Penalty Proceedings under the Corporations Act' (2003) 8 *Company and Securities Law Journal* 507.

15 *Corporations Act* s 1332.

16 Rubenstein, above n 8, 110.

17 *Corporations Act* s1317G(1B) provides for such penalties if, pursuant to s 1317G(1A), the contravention: (i) materially prejudices the interests of acquirers or disposers of the relevant financial products; (ii) materially prejudices the issuer of the relevant financial products or, if the issuer is a corporation or scheme, the members of that corporation or scheme; or (iii)is serious.

2 a compensation order made in favour of the relevant company in which the financial products were traded;[18]

3 a compensation order made in favour of any person who suffers damage as a result of the relevant trading;[19] and

4 potential disqualification from managing a corporation for whatever period the Court considers appropriate.[20]

The civil penalty regime was primarily introduced in relation to insider trading to provide an alternate means of pursuing alleged insider traders, with a greater prospect of success. This is well described in the Explanatory Memorandum to the *FSR Bill*:

> [A] major problem that exists in relation to the market misconduct and insider trading provisions, is the difficulty ASIC has in successfully prosecuting a breach of the provisions. As the existing provisions are offence provisions, the criminal burden of proof (beyond reasonable doubt) applies. ASIC has found it difficult to prove elements of the offences beyond reasonable doubt, as many elements refer to the defendant's state of mind. This difficulty may result in cases not being pursued even where there has been a breach of the provisions. This is undesirable as it casts the law into disrepute, and also threatens the integrity of financial markets. It is therefore proposed to make the market misconduct and insider trading provisions civil penalty provisions. The application of the civil burden of proof (balance of probabilities) will facilitate the bringing of actions for breaches of the provisions. The application of civil penalties is likely to act as a deterrent to market misconduct.[21]

III EFFECTS OF *FSR ACT* REFORMS ON INSIDER TRADING

The three *FSR Act* insider trading reforms have, so far, had varying degrees of observable success and influence.

A *Extension of Insider Trading Prohibition to all Division 3 Financial Products*

Whilst the enlargement of the scope of 'products' to which the insider trading prohibition applies has undoubtedly had a significant influence on the compliance obligations placed on businesses which operate in the financial services industry (the impost of which should not be underestimated) there has been little discernable impact in any other respect. For example, there have been no reported instances of action being taken or threatened over any alleged insider trading in respect of the new 'class' of products now caught within the definition.

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18 *Corporations Act* s 1317J(2).
19 *Corporations Act* s 1317J(3A).
20 *Corporations Act* s 206C.
21 Explanatory Memorandum, *FSR Bill*, [2.78] to [2.79].

One significant issue which has been given visibility as a result of the *FSR Act* insider trading reforms is the efficacy of applying the insider trading legislation to different financial markets, in particular the difficulties which may arise in relation to 'over-the-counter' (or OTC) derivatives. OTC derivatives are traded on the basis of 'principal-to-principal' contracts entered into off an exchange, which are negotiated and documented by sophisticated professional parties to suit their particular circumstances, where there is no obligation to make public disclosure.[22] This is to be contrasted with securities traded on an exchange, where the identity of the other party is not generally known, and which occur in a market where continuous disclosure obligations apply.

Various difficulties have been identified in applying the insider trading prohibition to OTC derivative products:

1 it may prevent genuine hedging, which is a common purpose for entry into OTC transactions. This is primarily because of knowledge which may be possessed by a party seeking to 'hedge' against a known risk – which may be the knowledge which gives rise to the very desire to hedge. Participants in OTC transactions typically engage in them to manage risk exposure rather than for the maximization of profits as on standard exchange based transactions - for example, they may seek to hedge against movements in price, interest rates or exchange rates.[23]

2 organisations which typically engage in OTC transactions, which were not previously subject to the insider trading regime, face significant costs and difficulty in ensuring compliance with the new requirements.[24]

It has been suggested that OTC transactions should be excluded from the insider trading regime because, as noted above, the OTC products and transactions are significantly different to those of exchange traded products in nature and function.[25]

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[22] Julian Donnan, 'Insider Trading and OTC Derivates under the Financial Services Reform Act' (2003) 14 *Journal of Banking and Finance Law and Practice* 32, 35 and 37; John O'Sullivan, 'Derivatives – A Survey of the Law and Practice' (1994) 5 *Journal of Banking and Finance Law and Practice* 89, 90; Shaun Ansell, 'The Regulation of Insider Trading in Derivatives' (1995) 13 *Company and Securities Law Journal* 476, 481.

[23] Donnan, above n 22, 38.

[24] Donnan, above n 22, 38.

[25] Donnan, above n 22, 38.

Following an extensive review of insider trading laws, the Corporations and Markets Advisory Committee[26] released its Insider Trading Report in November 2003.[27] A key recommendation of that report, supported by the majority of the Advisory Committee, was that the prohibition should be focused,[28] with divergence between the majority and minority of the Advisory Committee as to whether there should be 'consequential amendments to meet the circumstances of different financial markets',[29] such as specialist OTC markets. CAMAC has indicated an understanding of the difficulties associated with applying insider trading laws to directly negotiated transactions, such as transactions on OTC markets and transactions in securities of unlisted entities. This issue currently remains unresolved and is being considered by the Commonwealth Treasury.[30]

The CAMAC majority proposed to address this issue by amending the prohibition on insider trading under s1043A of the *Corporations Act* so that it only applies if:

> (ba) the inside information is disclosable information or announceable information.[31]

New definitions of 'disclosable information' and 'announceable information' would then be added to s1042A of the *Corporations Act*:

> '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 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 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).[32]

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26 To be referred to from now on as the 'CAMAC'.
27 This report is available online at: http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFFinal+Reports+2003/$file/Insider_Trading_Report_Nov03.pdf.
28 Recommendation 38 in the CAMAC Insider Trading Report.
29 CAMAC Insider Trading Report, 61.
30 Commonwealth Treasury Insider Trading Position and Consultation Paper, March 2007, available online at http://www.treasury.gov.au/contentitem.asp?NavId=&ContentID=1235.
31 CAMAC Insider Trading Report, 61.
32 CAMAC Insider Trading Report, 61-62.

The CAMAC minority opposed this recommendation on the basis that any issues concerning specialist markets, such as OTC markets, should be addressed by the use of appropriate defences or carve-outs tailored to the relevant circumstances.[33]

The CAMAC minority position is preferred, because it would avoid the insertion of further difficult and convoluted definitions into the *Corporations Act*, which would be the result of the majority position recommendation. These provisions carry the risk of creating retrospective offences, because it will not necessarily be determinable at the time a transaction is entered into whether or not certain information is 'inside information'. As noted in the Commonwealth Treasury Insider Trading Position and Consultation Paper,[34] any element of retrospectivity 'undermines the certainty and predictability of the justice system.' However, the minority position lacks any suggested defences or carve-outs for review or assessment.

It is worth noting that certain additional amendments were made by the *Financial Services Reform (Consequential Provisions) Act* 2002 (Cth) to, in part, address the issue of OTC transactions, by amending the 'own intentions exceptions' in ss 1043H-1043J of the *Corporations Act.* These amendments primarily extended the 'own intentions exceptions' to knowledge of proposed transactions rather than just transactions which had already taken place, as well as transactions entered into by third parties. However, it is acknowledged that these amendments 'did not solve the inherent problem of applying the … insider trading provisions to all financial product transactions'.[35]

The Commonwealth Treasury has recognised the difficulties associated with this issue and has, through its Insider Trading Position and Consultation Paper, sought submissions on alternative means of dealing with OTC derivative products.[36]

B *Widening of the Type of Conduct Caught by Insider Trading Prohibition*

In common with the reform described above – the extension of the insider trading prohibition to all Division 3 financial products – the widening of the type of conduct caught by the insider trading prohibition has, so far, had little discernable impact on insider trading in a practical sense.

However, it cannot pass without comment that there is arguably a remaining loophole within the type of conduct caught by the insider trading prohibition. As noted above,[37] the reform of the type of conduct prohibited would now arguably avoid the same outcome as that in the *Evans and Doyle case,* because the newly

[33] CAMAC Insider Trading Report, 62.
[34] Commonwealth Treasury, above n 30, 18.
[35] Commonwealth Treasury, above n 30, 18.
[36] Issues 5A and 5B, Commonwealth Treasury, Insider Trading Position and Consultation Paper, above n 30, 20.
[37] At paragraph II B of this paper.

inserted phrase 'apply for' would now encompass the placing of a 'buy order' on SEATS, which previously fell outside the relevant definition.

However, what of a 'sell order' placed on SEATS? In order for there to be 'regulatory neutrality',[38] those who place orders to sell financial products because they are in possession of inside information should be in the same legal position as those who place orders to buy. The term 'apply for' cannot refer to placing a sell order and, on the basis of the as yet undisturbed reasoning in the *Evans and Doyle case,* the term 'dispose of', which must have almost the same meaning as the previously used term 'sell', would not cover the placing of a sell order which is not yet fulfilled.

The CAMAC suggested in its Insider Trading Report[39] that there should be clarification of the relevant time when liability arises where trading occurs through an intermediary, such as a broker. The CAMAC considers that there are three possible points of time in which liability could arise when trading through an intermediary:

1 when the intermediary is instructed by the client;
2 when the intermediary makes an offer on the market on the client's behalf; or
3 when the offer is accepted by another trader (which is the point in time which was deemed to be relevant in the *Evans and Doyle case*).

The CAMAC's recommendation is that, whilst a person should not be liable for insider trading unless a transaction ultimately takes place, the relevant time at which liability should arise, is when the person instructs an intermediary to act on their behalf.[40] This would be the time at which the person would be deemed to 'enter into an agreement' to acquire or dispose of Division 3 financial products. The Commonwealth Treasury has indicated that it agrees with this position.[41] Once legislated, this will hopefully close this existing legal loophole.

C *Introduction of Civil Penalty Proceedings for Insider Trading*

The *FSR Act* reform which has arguably had the most impact on the law regarding insider trading is the extension of the civil penalty regime to insider trading and market misconduct offences. In particular, two decided cases have already resulted from this reform:

1 *ASIC v Petsas and Miot*;[42] and

38 A stated aim of the financial services reforms: Australian Treasury Department Corporate Law Economic Reform Program – Policy Framework (1997).
39 CAMAC Insider Trading Report, at [1.5].
40 Ibid.
41 Commonwealth Treasury, Insider Trading Position and Consultation Paper, above n 30, 6.
42 (2005) 23 ACLC 269; [2005] FCA 88; to be referred to from now on as the '*Petsas case*'.

2 *ASIC v Citigroup Global Markets Australia Pty Ltd,*[43]

both of which are worthy of some discussion.

1 *The Petsas Case*

The *Petsas case* is noteworthy primarily because it was the first set of proceedings in which the ASIC made use of the civil penalty regime for insider trading. Briefly, Mr Petsas was an employee at ANZ Banking Group, which had been retained by BRL Hardy Ltd (BRL) to advise on a confidential merger proposal. On the day Mr Petsas became aware of the proposal he provided details to his friend, Mr Miot, and they immediately purchased option contracts over BRL shares in Mr Miot's name, for just over $35,000. The next day, the merger discussions were publicly announced and the price of BRL shares rose significantly. Mr Miot sold the contracts later that day, for a profit of approximately $128,500. A settlement was reached, and the parties consented to an order that Mr Petsas and Mr Miot had contravened the civil penalty proceedings for insider trading. Mr Petsas and Mr Miot were each ordered to pay a fine ($75,000 for Mr Petsas and $65,000 for Mr Miot), to return their profit to the other parties to the option contracts, and to pay approximately $93,000 in respect of the ASIC's costs.

Interesting issues which arose from this case were the criteria which His Honour, Finkelstein J, considered were relevant to determining the appropriate sentence for an insider trader found liable under the new civil penalty proceedings:

(a) Breach of Trust

The conduct of Mr Petsas was considered to be more serious than that of Mr Miot, because of the misuse of information he acquired due to his employment.[44]

(b) Sentences for Criminal Convictions

Benchmarks against what would have been a likely sentence if a criminal conviction were obtained instead were considered useful. Finkelstein J suggested that 'even a first time offender who pleads guilty [in a criminal prosecution] is likely to suffer a term of imprisonment … of between three to six months'[45] and considered whether it is possible to calculate the monetary value of a term of imprisonment, to then be imposed as a fine. Using conversion calculations possible under the *Crimes Act* 1914 (Cth),[46] his Honour suggested that a fine of $200,000[47] is

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43 [2007] FCA 963 (28 June 2007); to be referred to from now on as the 'Citigroup case'.

44 The *Petsas case* [11].

45 This statement is not necessarily borne out when considering sentences imposed on convicted insider traders such as Mr Robert 'Bart' Doff, who received only a fine of $30,000 and 350 hours of community service when convicted of insider trading after pleading 'not guilty': *R v Doff* (2005) 23 ACLC 317; [2005] NSWSC 50.

46 *Crimes Act* 1914 (Cth) s 4B.

the equivalent of a life sentence. However, as this formula does not take into account the cost to the offender of a criminal conviction – earnings lost whilst in prison, the loss of freedom, stigma which attaches to a criminal conviction and the future effect on employment and travel[48] it is of limited utility. Additionally, it is questionable whether it is appropriate to consider the criminal sanctions which could have been imposed. If criminal proceedings had been pursued, a conviction may not even have been obtained due to the greater burden of proof and stricter application of the rules of evidence. Additionally, as civil penalty proceedings are an alternative to criminal proceedings, it is arguably not appropriate – having elected to pursue a civil penalty – to then refer to the potential consequences of the abandoned criminal proceedings.[49]

(c) Purpose of Imposing a Civil Penalty

Finkelstein J noted that there are dual purposes for imposing a civil penalty – punishment and deterrence.[50] This is consistent with the general view of civil penalties under the *Corporations Act.*[51]

(d) Conduct of Defendant

Finkelstein J considered that a plea of guilty, which spared the cost of a trial, should be taken into account.[52]

(e) Personal Circumstances of the Defendant

Personal circumstances, such as a defendant's employment and likely future ability or inability to obtain employment, and expressions of remorse, were considered to be relevant considerations.[53]

Finkelstein J also made some interesting and pertinent comments in relation to the conduct of civil penalty proceedings, which he noted '… may [now] be chosen by the enforcing authority as an express alternative to a criminal prosecution'.[54] The stated benefits of the civil penalty proceedings were that they are likely to be cheaper, more efficient, apply the rules of evidence less strictly, afford fewer

47 The maximum fine which can be imposed on an individual as a civil penalty for insider trading.

48 The *Petsas case*, [14].

49 For further discussion of this issue, see Juliette Overland, 'Two Steps Forward, One Step Back: Assessing Recent Developments in the Fight Against Insider Trading' (2006) 24 *Company and Securities Law Journal* 207.

50 The *Petsas case* [17].

51 Middleton, above n 15; *ASC v Donovan (*1988) 28 ACSR 583, 608 per Cooper J; *ASIC v Adler* [2002] NSW SC 483, [125] per Santow J; *ASIC v Whitlam* [2002] NSWSC 718, [6] per Gzell J; *ASIC v Forge* [2002] NSWSC 760, [155] per Foster AJ; *ASIC v Doyle* [2002] WASC 223, [20].

52 The *Petsas case* [18].

53 The *Petsas case* [19].

54 The *Petsas case* [1].

protections to defendants, with a lower standard of proof, giving a greater likelihood of a successful action.[55]

2 *The Citigroup Case*

This is a controversial and much publicised set of proceedings, and was the second case instituted by the ASIC under the civil penalty regime for insider trading. The case is particularly significant because the defendant was a corporation, not an individual, and if the proceedings had been successful it would have been the first time a corporation had been found liable for insider trading in Australia.

The ASIC instituted proceedings for insider trading against Citigroup on 31 March 2006 and judgment was delivered by His Honour, Jacobson J, of the Federal Court of Australia on 28 June 2007. These proceedings arose out of the takeover bid for Patrick Corporation Limited (Patrick) by Toll Holdings Limited (Toll), in which Citigroup acted as an adviser to Toll through its Investment Banking Division. The ASIC had alleged that, on the day prior to the announcement of the takeover bid, Mr Manchee, a Citigroup employee who was engaged in proprietary share trading – that is, trading on Citigroup's own behalf rather than for its clients – purchased over one million Patrick shares. This trading was noticed by the Investment Banking Division. An executive in the Investment Banking Division then asked Mr Manchee's manager, Mr Darwell, who was undertaking the trading and, when told, stated words to the effect that 'we may have a problem with that'. Mr Darwell took Mr Manchee outside and told him to stop buying Patrick shares. Mr Manchee then returned to the office and began *selling* Patrick shares.

These circumstances gave rise to two claims of insider trading against Citigroup:

1 the ASIC alleged that the proprietary trading by Mr Manchee, which occurred after he was told by his manager to stop buying Patrick shares, amounted to insider trading attributable to Citigroup; and

2 the ASIC alleged that there was not an effective 'Chinese wall' in place so that all proprietary trading by Mr Manchee amounted to insider trading because of the inside information possessed by executives in the Investment Banking Division advising Toll on the proposed takeover of Patrick.

The case also gave rise to issues of 'conflict of interest' management and breaches of fiduciary duties.[56]

It is interesting to review the reasoning of Jacobson J on the relevant issues:

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55 The *Petsas case* [2].

56 Jacobson J ultimately determined that there was no duty to avoid a conflict of interest because of the absence of a fiduciary relationship between Citigroup and Toll, but a discussion of those issues is beyond the scope of this paper.

(a) The First Insider Trading Claim

The first insider trading claim ultimately failed because the proprietary trader was not found to be an 'officer' of Citigroup – primarily because he was an employee not involved in management.[57] Section 1042G(1)(a) of the *Corporations Act* provides that knowledge is attributed to a corporation if it is possessed by a company officer who acquired it in the course of their duties. Interestingly, Jacobson J chose not to consider any alternative common law rules which may operate to attribute knowledge to a corporation.[58]

Additionally, as a matter of fact, it was found that the proprietary trader had not made the necessary supposition alleged by the ASIC – that Citigroup was acting for Toll on an imminent takeover of Patrick[59] – and that such a supposition had not been conveyed to the proprietary trader by his manager.[60]

(b) The Second Insider Trading Claim

The second insider trading claim ultimately failed because Citigroup's 'Chinese wall' was found to satisfy the necessary requirements to defend an action for insider trading. Although officers of Citigroup, in the Investment Banking Division acting for Toll, were aware of relevant 'inside information' concerning Patrick shares, at a time when trading in those shares was occurring in another part of the organisation, the 'Chinese wall' was found to be effective.

Section 1043F of the *Corporations Act* provides that a corporation does not contravene the insider trading prohibition merely because information is in the possession of an officer or employee if:

> (a) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than that officer or employee; and
> (b) it had in operation at that time arrangements that could reasonably be expected to ensure that the information was not communicated to the person or persons who made the decision and that no advice with respect to the transaction or agreement was given to that person or any of those persons by a person in possession of the information; and
> (c) the information was not so communicated and no such advice was so given.

Jacobson J found that Citigroup had an effective 'Chinese wall' in place and that there was no breach of the wall – thus no insider trading took place.[61]

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57 The *Citigroup case* [479]-[515].

58 For a detailed discussion of this issue, see Juliette Overland, 'There Was Movement at the Station for the Word had Passed Around: How does a Company Possess Inside Information under Australian Insider Trading Laws?' (2006) 3 *Macquarie Journal of Business Law* 241.

59 The *Citigroup case* [502]-[505].

60 The *Citigroup case* [516]-[525].

61 The *Citigroup case* [579]-[598].

On matters of law, the *Citigroup case* also makes some interesting pronouncements on insider trading:

1 it was stated that an uncommunicated supposition can constitute 'information', as can inferences or suppositions drawn from words or conduct;[62]

2 it gave confirmation that the test of whether information is readily observable is not whether the matter was widely observed but whether it could have been;[63] and

3 to have an effective 'Chinese wall' it is not necessary to achieve a 'standard of absolute perfection' or to ensure that 'every conceivable risk is covered by written procedures'.[64]

An interesting issue demonstrated by the *Citigroup case* is the fact that the ASIC was able to combine two separate causes of action – claims of insider trading and conflict of interest claims – in the one set of proceedings. As the claims arose from the same set of circumstances, this no doubt carried significant benefits for both sides as a result of the avoidance of duplication and overlap, despite the fact that the actions were ultimately unsuccessful. This would not have been possible if the civil penalty regime had not been introduced for insider trading – the insider trading case would have to have been run as a criminal prosecution by the Department of Public Prosecutions and the conflicts of interest claims as a separate civil action by the ASIC. Thus the ability for the ASIC to combine insider trading proceedings with other civil actions must be seen as an attendant benefit of the civil penalty regime for insider trading.

IV BACK TO THE FUTURE? – CONCLUDING REMARKS

As has been discussed, in a practical sense, the financial services reform which has had the most noticeable effect on insider trading in Australia has been the extension of the civil penalty regime to insider trading.

The extension of the insider trading prohibition to all Division 3 financial products has lead to concern over its operation in certain markets – particularly in relation to OTC derivative products. The CAMAC has not been united in its recommendations to deal with this issue and the Commonwealth Treasury has sought public submissions. The date for responses to the Insider Trading Position and Consultation Paper closed on 2 June 2007 and a report from the Treasury has not yet been released, but it is hoped that the uncertainty surrounding the operation of insider trading in the OTC markets can be satisfactorily clarified.

62 The *Citigroup case* [542].
63 The *Citigroup case* [551].
64 The *Citigroup case* [591]-[592].

The widening of the scope of the conduct caught by the insider trading prohibition has closed one loophole but opened another. Although a situation similar to that arising in the *Evans and Doyle case* – where the placing of a 'buy' order on SEATS was found to fall outside the prohibition - would now be avoided, the placing of a 'sell' order alone still appears to unregulated. However, this loophole will be closed if the CAMAC recommendation is adopted so that the *Corporations Act* is amended to provide that, if a person instructs an intermediary to act on their behalf, the relevant time at which liability arises is the time at which the intermediary is instructed.

Despite the ASIC's lack of success in the *Citigroup case,* the availability of civil penalty proceedings against alleged insider traders is still likely to lead to an increase in the number of proceedings instituted in the near future and may still lead to an 'invigoration of litigation for insider trading'.[65] It clearly provides more options for the ASIC when confronted with complex insider trading cases, even though criminal proceedings may remain the preferred option due to the great symbolic value of criminal sanctions.[66] One issue that has been highlighted by the *Citigroup case* is that whilst civil penalty proceedings have certain advantages over criminal prosecutions, which make it easier to proceed against alleged insider traders, they do not resolve all problematic issues concerning insider trading. Indeed, the *Citigroup case* can be said to demonstrate that even with the benefits of civil penalty proceedings, the complexities and technicalities associated with pursuing alleged insider traders remain – difficulties in detecting insider trading; complexity of insider trading laws and interpretational difficulties; limited judicial consideration of insider trading laws and inconsistent judicial interpretation; and in particular the difficulty in proving the knowledge elements of the offence.[67]

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[65] Gregory Lyon and Jean J du Plessis, *The Law of Insider Trading in Australia* (2005) 155.

[66] Vivien Goldwasser, 'CLERP 6 – Implications and Ramifications for the Regulation of the Australian Financial Markets' (1999) 17 *Company and Securities Law Journal* 206, 212.

[67] See, for example, Rubenstein, above n 8; Roman Tomasic and Brendon Pentony, 'The Prosecution of Insider Trading: Obstacles to Enforcement' (1989) 22 *Australian and New Zealand Journal of Criminology* 65; Roman Tomasic, *Casino Capitalism?: Insider Trading in Australia* (1991) 115-126; Explanatory Memorandum, *FSR Bill* [2.78]-[2.79]; Lyon and du Plessis, above n 65, 163-168.