COMMENTS

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NCSC DISCUSSION PAPER ON INSIDER TRADING — WHO SHOULD BE CONSIDERED AN 'INSIDER'?

Insider trading is very much in the news.[1] Major scandals are unfolding in New York and London. Heads will roll. Some already have. Things are quieter in Australia. At least for the moment. However, it is clear that the National Companies and Securities Commission (NCSC) is concerned and has been for some time. Increased activity in the area of takeovers with the resulting possibility of tremendous gain has heightened this concern.

A Discussion Paper was commissioned several years ago by a working party of the NCSC established in 1983 to examine the law relating to insider trading.[2] The report was written by a Canadian, Dr Philip Anisman, a former professor at Osgoode Hall Law School, York University, Toronto. Anisman is currently in private practice in Toronto. The report concludes by recommending a scheme of regulation based on the Canadian model. Anisman firmly rejects arguments in favor of deregulating insider trading.[3] Compared to the present Australian legislation relating to insider trading (Securities Industry Code ss128-130), the proposals suggested in the report are for legislation which is substantially broader.

One major issue which this report does not consider is whether more extensive regulation is necessary at this stage. The report assumes that more regulation *is* necessary. Many would argue otherwise. Clearly the legislation could be improved, but it is not obvious that the apparent lack of prosecutions in Australia is due to insufficient legislation rather than lack of enforcement resources. The current legislation is already quite

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1 'Insider Trading' is commonly understood to be the improper or illegal use of non-public, price-sensitive information when buying or selling securities. Such a definition is a restricted definition in that it is limited to the *illegal* use of such information. This comment uses the restricted definition as does Dr Anisman in his Discussion Paper, infra.

2 Anisman, *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* (National Companies and Securities Commission Consultative Paper 1986).

3 Ibid 7-9.

broad in that it covers directors, employees, substantial shareholders and individuals in a professional or business relationship with the company.[4] It also covers certain classes of tippees. In many ways it is broader than the legislation in the United States. Despite that fact there have been few investigations and even fewer (if any) prosecutions.[5]

Anisman's report can be divided into four major parts. The first (Chapters One through Three) deals generally with the scope of insider trading legislation; specifically, who should be included in the category 'insider', what constitutes 'inside information' and what is the precise conduct to be proscribed. This is the most theoretical part of the report as it deals with issues of policy and scope. It also provides the basis for concrete proposals found later in the report. The position of the author is obvious. Every type of trading that has any special informational advantage should be prohibited. The term 'insider' should include any individual, group, company or 'business combination' that has possession of 'material' non-public information, whether such individual, etc has a relationship to the company concerned or not. In sum, the scope of the regulation should be as broad as possible.

The second part of the report (Chapter Four) deals with sanctions. Not surprisingly, Anisman suggests heftier penalties for insider trading, including expanded liability for tipping. Stronger penalties have been adopted recently in the United States. The United States Insider Trading Sanctions Act now permits the imposition of treble damages for insider trading.[6] Anisman presents a scheme which would also permit double or treble damages.[7] In addition, he advocates a clearer distinction between civil and criminal penalties than exists in the current Australian statute. He also proposes that the NCSC should be able to bring an action for compensatory damages with the damages to be paid into a special fund. The current statute only permits such an action by a party who has sustained a loss or by the company that issued the securities.[8]

With respect to the statute of limitations, the report recommends the adoption of the Canadian limitation in preference to the current Australian limitation of two years from the date of the transaction.[9] The Canadian limitation is two years from discovery of the transaction but in no case more than six years from the date of the transaction. The Canadian limitation is also similar to the American Law Institute's proposal of one and five years respectively. Such a change would clearly make sense since detection of insider trading can be very difficult. Another proposal

4 For example, in the United States a fiduciary relationship is required to impose liability for insider trading, *Chiarella* v *US* (1980) 445 US 222, while in Australia only a business relationship is necessary, Securities Industry Code, s128(8).

5 It has recently been reported that the NCSC has reactivated an investigation into a possible case of insider trading referred to the NCSC over a year ago. The reason given for not pursuing the investigation earlier was lack of resources. *The Age* 11 February 1987.

6 See Securities Exchange Act of 1934 s21(d)(2) (inserted by the Insider Trading Sanctions Act 1984).

7 See Discussion Paper, supra n 2, at 106ff. Treble damages would mean the possibility of imposing damages equal to three times the profit obtained from any instance of insider trading.

8 Securities Industry Code, s130(1). It should be noted, however, that Securities Industry Code s129 does permit the imposition of a fine of up to $20,000 in the case of an individual and up to $50,000 in the case of a corporation.

9 Supra n 2 at 124-126.

of the report is for the provision of administrative sanctions as well as criminal and civil penalties.[10] For example, the NCSC could be given power to prohibit offenders from further trading on the securities markets. The ability to impose administrative sanctions would give the NCSC a great deal more power when dealing with stock exchange professionals. Administrative sanctions have been used extensively by the Securities and Exchange Commission in the United States.[11]

The third part of this report is a model insider trading statute[12] which incorporates the recommendations made in the text. When compared to the current Australian statute three major differences can be seen. First, Dr Anisman's proposals are much clearer, that is, easier to read and understand. The length is probably about the same. However, the proposals address several issues which are unclear and unresolved under the current provisions. On the other hand, some of the purposely vague or broad definitions are certain to cause problems. The second major difference is that the proposals are much broader and all inclusive than the current Australian statute. As mentioned earlier, the definition of 'insider' is much wider, as is tippee liability. 'Insider' is no longer defined in terms of directors, employees, substantial shareholders and individuals with a professional or business relationship with the company. In addition to individuals with defined types of relationships to a company, persons in possession of inside information obtained from an insider are also 'insiders'.[13] For example, Government employees with access to inside information would be included. Thus, it is the possession of inside information which is determinative.

From the prospective of a company the proposed broadening of the definition of 'insider' should not cause concern. Individuals connected to a company are already covered under the current legislation. The proposals would merely extend the prohibition against trading to all individuals and companies that have possession of 'inside information'. This, in fact, should offer additional protection to companies when others have access to inside information but lack the requisite relationship to the company required by the current legislation.

'Information' is also defined more broadly. The term in a New South Wales statute (s75A of the New South Wales Securities Industry Act 1970) similar to the current statute (s 128(2)) has been construed in *Ryan* v *Triguboff*[14] as limited to facts. Such a limitation seems unreasonable given the importance attached to the opinions of insiders by the investing community. However, the proposed new definition of 'material inside information' is less precise than the current definition and this vagueness may cause problems for everyone. The prohibitions against trading only apply when the information possessed is 'material'. The current definition requires that the 'material' information be price-sensitive, that is, likely to affect the price of the company's shares. This is sensible given that the purpose of the legislation is to protect shareholders and the shareholders' principle concern is the price or value of their investment.

10 Ibid 128-129.
11 Ibid Notes 708 and 928.
12 Ibid 132-157.
13 Ibid 133, Proposed Statute s1(1)(e)(vii).
14 [1976] 1 NSWLR 588.

The proposed definition, however, refers to 'information to which a reasonable person would attach importance under the circumstances in determining to purchase or sell securities', or 'information known to be deemed important in a face to face transaction whether or not it is, in reality, important'.[15]

The kind of mischief that this definition may occasion leads one to wonder why bother. Wouldn't it be better to leave 'material' undefined and let the courts make that determination in each case? Certainly the definition is of no real help as a case by case determination will have to be made in any event.

In addition to the broader definition of 'material information' it is clear also that it is more difficult for information to become 'public' under the proposals. It is debatable exactly what the current statute requires with respect to the 'general availability' of information. Does it require mere publication or does it require more? The Anisman proposal requires (1) a filing (2) a press release or (3) another form of publicity likely to bring the information to the attention of a reasonable investor and a reasonable period of time for dissemination of the information.[16] It appears that the requirement of a reasonable amount of time for dissemination of the information was meant to apply to all three types of disclosure (ie filing, press release or other form of publicity) and that the restriction to the third type of disclosure is a typographical error.[17]

Two loopholes which exist in the current legislation would be closed by the proposed statutes. The first involves the issue of who is a 'tipper'. In the recent case of *Hooker Investments Pty Ltd* v *Baring Bros, Halkerson & Partners Securities Ltd*,[18] the court held that s128(3) only applied to a natural person and not a body corporate. Thus, a body corporate could not be a tipper. The *Hooker* case has an illogical result given the general tenor of s128. The loophole should be closed. Another loophole which the proposed statute would close is the fact that s128 does not include equity options.[19] Closing the equity option loophole is necessary given the fact that equity options are the favored vehicle for insider trading.

The third major difference between the current legislation and the proposals is that prosecutions should be easier under the proposed statute. This is due in great part to the broader terminology used. Liability is both quantitatively and qualitatively increased.

The proposals of Anisman do not have much sympathy for the position of the sharebroker/investment advisor. Basically they are treated like anyone else who possesses inside information: they cannot deal nor may they advise others to do so.[20] This position may be supported by the

15 Supra n 2 at 133, Proposed Statute s1(1)(f).
16 Ibid, Proposed Statute s1(1)(g).
17 Discussion with Dr Anisman, 26 February 1987.
18 (1986) 4 ACLC 243.
19 This is due to the manner in which 'securities' is defined by the Securities Industry Code. See Securities Industry Code ss4(1) and 4(8A).
20 Supra n 2 at 35-42.

recent investigation of sharebrokers and arbitraguers in New York.[21] Institutional investors and their insiders are also prohibited from trading in securities of portfolio companies when they are in possession of inside information. The Chinese Wall defence is maintained,[22] however, despite the general criticism that Chinese Walls always leak.

The fourth and last part of the report is the Note Section. It can be considered a separate section because of its length and lack of integration with the text. The Discussion Paper, including the model statute, runs to 157 pages. The notes run to 132 pages of much smaller print. Obviously, the material contained in the notes is of a more detailed nature, of interest to a much smaller and more specialized audience. The notes provide a wealth of information on United States and Canadian cases and other authorities dealing with insider trading.

Reviewing the wealth of authority elsewhere and the lack of the same in Australia underscores the question of the relevance of this study. The current Australian statute is not enforced even with respect to primary insiders (that is, directors, employees and substantial shareholders). Broadening the statute and increasing the penalties will not solve the problem of enforcement. Greater penalties for insider trading will not be effective if unenforced. Insider trading is a serious problem with far reaching consequences. Recent studies (for example, the study of takeovers commissioned by the NCSC[23]) make it clear that there is a great deal of insider trading going on in Australia, yet there have been no prosecutions and few investigations. Perhaps this is about to change.[24] Arguably, a new statute which is broader in scope and easier to understand may make enforcement easier. If so, it is to be commended. However, the complete dearth of insider trading cases in Australia suggests that the problem is not losing cases, but rather not making cases in the first instance.

21 In May 1986 the Securities & Exchange Commission (SEC) charged Dennis Levine, a well-paid merger and acquisitions specialist on Wall Street, of illegally using advance information of 54 impending mergers and acquisitions to rack up multi-million dollar profits from trading stocks and options. Mr Levine has cooperated with the SEC in their ongoing investigation. In November 1986, the SEC announced that Ivan Boesky, one of America's richest stock-market speculators, had also been caught. He agreed to pay $100 million in penalties and like Levine faces criminal charges. In February 1987 several other prominent individuals from top Wall Street investment firms were arrested (see *Time* 23 February 1987, 62-64). The investigation continues.

22 Supra n 2 at 146, Proposed Statute s7(7).

23 Round and McDougall, *Australian Research on Corporate Takeovers* (1986) Research Report No 3.

24 See supra n 5.