POLICIES IN THE REGULATION OF INSIDER TRADING AND THE SCOPE OF SECTION 128 OF THE SECURITIES INDUSTRY CODE

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[*Insider trading in the last decade has become an area of increasing debate and concern. The author begins by analysing the economic basis for the regulation of insider trading, and notes the effect of competing principles on subsequent decisions of the courts. These principles are utilized in a discussion of the constituent elements of insider trading which refers to the practical effects of and inherent problems and conflicts within the scope of the current statutory regime. The author particularly notes the unsuitability of the relevant civil remedies to trading on a public market, the unresolved issue of extra-territorial application of the legislation, and the difficulty of detecting insider trading in public markets without the substantial commitment of regulatory resources.*]

Introduction

The Issues Paper prepared by Philip Anisman for the National Companies and Securities Commission on the subject of insider trading[1] appears unlikely to lead to substantial restructuring of insider trading regulation in Australia, given the largely unfavourable market and political responses to Anisman's proposals. It is therefore an appropriate time to review the approach to insider trading adopted under Sections 128 and 130 of the Securities Industry Code ('the Code').[2] Such a review should take account of the conceptual and policy issues raised by Professor Anisman's Report.

There are three central elements to legislation dealing with insider trading: the issue of which persons are 'insiders' and within the scope of a prohibition upon insider trading; the question of the range of conduct which is to be categorised as 'insider trading'; and the consequences to follow from the breach of insider trading legislation, involving both the penalties to be imposed upon the trader, the remedies available to persons injured by the insider trading, and the defences which should be available to the insider. It is the first and second issues which will receive primary emphasis here.

There is at least an argument that insider trading regulation may be achieved as effectively through self-regulation of the securities market, with or without statutory support, as through a direct legislative prohibition. Whether self-regulation can achieve the benefits claimed by its proponents — in particular, in securing

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1 Anisman, P., *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives*, An Issues Paper prepared for the Working Party on Insider Trading of the National Companies and Securities Commission, (1986).

2 It might be noted that, although Anisman frequently cites particular provisions of the present legislation, his Report makes no concerted attempt to identify such provisions as either effective or ineffective in achieving their purpose. This deficiency is noted by Hogan, W., 'Insider Trading' (1988) *Companies and Securities Law Journal* 39, 42. Professor Hogan's critique of the Anisman Report was published after this article had been submitted for publication. The article has been partly revised to make reference to several of Professor Hogan's conclusions.

flexibility and promoting voluntary compliance — will depend on the commitment of self-regulatory bodies to discipline their members and their market 'clients', on the extent to which those clients are prepared to accept the authority of the self-regulatory bodies and comply with their directions, and on the extent to which the self-regulatory bodies have the confidence of investors in the market.

The possibility of increased scope for self-regulation of the securities markets in Australia is perhaps more open than in the past given recent moves in the United Kingdom to self-regulation upon a statutory basis[3], and given the willingness of the present Federal Government to consider a restructuring of the scheme of companies and securities legislation. The issues raised by self-regulation are too substantial to be addressed here, although it might be suggested that self-regulation would require a degree of voluntary compliance and respect for the regulatory institutions which may not be available from participants in the Australian securities market.

We need to begin here with at least a working definition of 'insider trading'. The central feature of conduct which could be characterised as insider trading, beyond the obvious requirement of the purchase or sale of securities, is the possession by the trader of information that is in some sense 'material' to the value of the securities traded, and is not information already publicly known, or more specifically known to others in the market.[4] It is the issue of whether information is known to others in the market which gives force to the characterisation of insider trading as 'essentially a problem of non-disclosure', originating in the access of the 'insider' to information which indicates a disparity between the value (or, perhaps more accurately, the future market price) of securities and their present market price.[5] The supporters of insider trading regulation argue that possession of such information makes market transactions essentially riskless for the insider.

Insider trading and the economics of the market

The policy arguments in favour for and against the existence of a regime for the control of insider trading have been the subject of academic argument which shows little sign of abating, and which reflects the participants' wider attitudes to the appropriateness of regulatory intervention in the market. In one sense, that

3 On the arguments as to whether self-regulation is effective in dealing with insider trading, Rider, B. A. K., *Insider Trading*, (1983), chapter 3; Mitchell, P. L. R., *Directors Duties and Insider Dealing*, (1982), chapter 8. For recent developments in the United Kingdom, Gower, L. C. B., *Review of Investor Protection*, (1984).

4 Dooley, M. P., 'Enforcement of Insider Trading Restrictions' (1980) 66 *Virginia Law Review* 1, 3; Ryan, P., 'The Current Australian Position' in *Securities Law Seminar: Insider Trading*, Faculty of Law, Monash University, (1985), 3.

5 Anisman, *op. cit.* 2. This characterisation of the nature of the insider trading issue was accepted in the submission to the N.C.S.C. of a Committee appointed by the Securities Institute of Australia: 'Trading on the Inside: Does Punishment fit the crime?' (1987) 2 *JASSA Journal of the Securities Institute of Australia* 6, 7, which recommended that insider trading might be addressed in part by increasing the level of disclosure required of companies, including requiring quarterly reporting by listed companies.

debate is of academic interest only, since it appears certain that Australia will continue to prohibit insider trading.[6]

Manne, the most influential academic critic of insider trading regulation, argued that insider trading itself gave rise to a prices signal to the market and moved the price of securities towards the real value of the securities, thus bringing about a better informed and more efficient market.[7] Manne further suggested that insider trading allowed entrepreneurs to receive financial rewards for innovation. It is said that the provision of information by this means reduces search costs for all participants in the market[8], while it is argued that insider trading is condoned in the market because its costs to the firm the shares of which are being traded are less than its benefits. These arguments are most commonly adopted in the American literature by those who accept the efficient market hypothesis, which holds that securities markets accurately reflect relevant information, including any inside information revealed only by trading on the market, in the price of shares traded.[9] These arguments have received some support from Australian commentators.[10]

The argument that insider trading provides a means of informing the market of information which companies would not by choice reveal has some force, although it must be qualified by the recognition that insider trading will likely be slower in affecting market prices, and less accurate as an indicator of underlying value, than would direct disclosure.[11] The opponents of insider trading regulation note that the comparison with direct disclosure is not to the point in the absence of a requirement that a company disclose all information which would be material to the market,[12] since companies will frequently choose not to disclose. On that reasoning, the proper comparison is between no information reaching the market and partial information becoming available through insider trading.[13]

6 Halstead, R. T., 'Insider Trading for Australia: Comments on the Green Paper Commissioned by the N.C.S.C.', Unpublished Seminar Paper, 1. Samuel observes that '[i]t is difficult if not impossible to argue concepts of economic efficiency against the intuitively attractive perceptions of fairness and equity': Samuel, G., 'Whither Australia — Directions for the Future' in *Securities Law Seminar: Insider Trading, op. cit.* 69.

7 Manne, H. G., *Insider Trading and the Stock Market* (1966); Levmore, S., 'Securities and Secrets: Insider Trading and the Law of Contracts' (1982) 68 *Virginia Law Review*, 117, 145; Hogan, *op. cit.* 44. Hogan reviews a number of empirical studies of the effect upon the American securities market of insider trading by persons associated with listed companies. He recognises that such studies draw upon information disclosed to the S.E.C. There is a strong probability of sample bias in the results, arising from non-disclosure of insider trading to the S.E.C. where disclosure would reveal breach of Rule 10b-5 by the insider.

8 Hogan, *op. cit.* 44.

9 Easterbrook, F. H., 'Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information' (1981) 11 *Supreme Court Review* 309, 326; Herzel, L., & Colling, D. E., 'The Chinese Wall and Conflict of Interest in Banks' (1978) 34 *Business Lawyer* 73, 94. Hogan, *op. cit.* 40-1, distinguishes the strong version of the efficient market hypothesis, which asserts that it is impossible for an individual participant in the market to earn consistently abnormal returns after deducting transaction costs, and the 'semi-strong' view which allows that 'there is scope for earning positive abnormal returns at least for brief period when private information is acted upon'.

10 Samuel, *op. cit.* 67; English, L., 'After Ivan Boesky' (1987) *JASSA: Journal of the Securities Institute of Australia* 8, 9.

11 Carlton, D. W., & Fischel, D. R., 'The Regulation of Insider Trading' (1983) 35 *Stanford Law Review* 857, 868.

12 Section 3A(1) of the Listing Rules of the Australian Stock Exchange requires a company to notify the Home Exchange as to information 'necessary to avoid the establishment of a false market in the company's securities which would be likely to materially affect the price of those securities'.

13 Easterbrook, *op. cit.* 327.

Where no information is released, and the insider is restrained from trading, then it is suggested that persons trading in the market will trade at values different from those which would have been established if all information had become available, while there will be an opportunity cost to the insider who is prohibited from trading.[14] It might be replied that it is inevitable, in anything less than a perfectly efficient market, that trades will occur at a value other than that which would have been established if the market had absorbed the entirety of relevant information. It may be that in partly efficient securities markets, such as the relatively shallow market on the Australian Stock Exchange, the release of no information is preferable to the disclosure of partial information through trading by insiders.

It has been noted that the suggestion that insider trading provides a desirable incentive for corporate officers is flawed since there is no necessity that the person benefiting from insider trading will be the person responsible for innovation, or that insider trading will reward him proportionately to the value of the innovation, while such trading allows insiders to profit from corporate failures. Moreover, the possibility of insider trading profits may encourage corporate insiders to withhold information from the market or to structure company transactions to allow a trading window.[15] The longer such information is withheld to serve the insider's trading interests, the more likely it is that the market will be misinformed and to the extent of such misinformation, inefficient.[16]

Insider trading and the integrity of the market

The supporters of insider trading regulation commonly also draw upon arguments as to the economic efficiency of the securities market, but typically argue that the prevention of fraud and the promotion of disclosure are necessary for the maintenance of an efficient market.[17] On this view, insider trading undermines investment in the securities markets by diminishing investors' confidence in the market's integrity. Such an argument appears to have been accepted by the Campbell Committee in observing that any advantages arising from insider trading in allowing the market to determine the underlying value of securities were outweighed by 'considerations of equity and likely adverse effects on investor confidence in the market as a whole'.[18]

Further, it is suggested that if insider trading results in a loss of confidence in the integrity of the securities market, investors will either look to other investment avenues, or will demand higher risk premiums, in either event increasing

[14] Hogan, *op. cit.* 48.

[15] Anisman, *op. cit.* 8; Brudney, V., 'Insiders, Outsiders and Informational Advantages under the Federal Securities Laws' (1979) 93 *Harvard Law Review* 322, 326-7; Levmore, *op. cit.* 150-1 Carlton & Fischel, *op. cit.* 858. It should be noted that Carlton & Fischel review these arguments in order to reject them.

[16] Anisman, *op. cit.* 8; Levmore, *op. cit.* 150-1.

[17] Anisman, *op. cit.* 6.

[18] *Final Report of the Committee of Inquiry into the Australian Financial System*, 1981, para 21.18. The reasoning of the Campbell Committee is criticised by Hogan, who suggests that it is inconsistent with the Committee's recognition in other contexts of principles of 'caveat emptor' and of the proposition that 'modest requirements for informing market participants' were conducive to market efficiency: Hogan, *op. cit.* 43.

the cost of capital to companies.[19] This argument is plausible, although it depends upon assumptions, which are not beyond question, as to the motivations of individual investors in the market and the extent of their risk aversion. Alternatively, it could be replied, following Manne, that the economic contribution of small investors to the market does not warrant the costs of prohibiting insider trading to secure their confidence.[20]

Supporters of insider trading regulation argue that in most cases it is not possible for an investor to distinguish companies where insider trading is occurring from companies in which it is not: therefore the 'rational investor' postulated by the efficient market theory will either refrain from trading or incur greater policing costs[21] or discount all securities in the market.[22] On this argument, the regulation of insider trading by legislation may be supported as a means of reducing the costs involved in individual investors seeking to police market transactions in which they are involved so as to avoid being disadvantaged against a trader with access to inside information.[23]

It may be that the most basic policy justification for legislation prohibiting insider trading lies in the assertion of the desirability of a minimum standard of 'fairness'[24] in the securities market, and of the benefits of legislative control of insider trading in the protection of individual investors.[25] If the regulation of insider trading has a 'prophylactic' function,[26] the objective of legislation must be partly to deny the insider any profit from insider trading.[27] On that reasoning, any efficiency advantages of prohibiting insider trading — for example in removing an incentive for insiders to withhold information from the market so as to allow them to trade on it — may be marginal, and a prohibition of insider trading justified on other than economic grounds.[28]

It must be noted, however, that an approach based on 'fairness' would not necessarily lead to the same conclusions as to the appropriate scope of the insider category as either a fiduciary approach — looking to the obligations arising from particular dealings in the market — or an economic approach. The 'fairness' criterion presumably requires a global assessment of the insider's dealings with all persons trading in the market at a particular time, while the fiduciary approach focuses upon duties arising in a particular relationship. Since the 'fairness'

19 Loss, L., 'The Fiduciary Concept as applied to Corporate Insiders in the United States' (1970) 33 *Modern Law Review* 34, 36; Brudney, *op. cit.* 335.

20 Manne, *op. cit.*; Samuel, *op. cit.* 60.

21 Brudney, *op. cit.*; Wang, W. K. S., 'Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is harmed, and who can sue under SEC Rule 10b-5?' (1981) 54 *Southern California Law Review* 1217, 1299.

22 Dooley, *op. cit.* 41; Easterbrook, *op. cit*, 326.

23 Brudney, *op. cit.*, 356; Levmore, *op. cit.*, 121.

24 The concept of 'fairness' is not without difficulty. Brudney & Clark suggest that the term has served as 'that last refuge of courts' faced with a divergence between the law and the presumed expectations of the parties, and that American case law gives it 'no principled content': Brudney, V., & Clark, R.C., 'A New Look at Corporate Opportunities' (1981) 94 *Harvard Law Review* 997, 1020.

25 Brudney, *op. cit.* n. 15, 334.

26 *cf.* on the 'prophylactic' function of fiduciary duties, Austin, R. P., 'Fiduciary Accountability for Business Opportunities' in: Finn, P. D., (ed.) *Equity and Commercial Relationships* (1987), 177; Weinrib, E. J., 'The Fiduciary Obligation' (1975) 25 *University of Toronto Law Journal* 1, 5.

27 Prentice, D., 'Insider Trading' (1975) *Current Legal Problems* 83, 92-93.

28 Brudney, *op. cit.* 334.

justification for insider trading regulation has an ethical basis, it would support a wider prohibition upon insider trading than is necessary for the maintenance of investor confidence or economic efficiency. A fiduciary justification of the prohibition equally has an ethical component, but is likely to be the least expansive of the possible sources of prohibition on insider trading since it depends upon the existence of a previous relationship giving rise to a duty of good faith, and does not easily extend to transactions at arm's length or an impersonal market.

The fiduciary principle and American law

Anisman's Issues Paper identified two groups of principles which might provide the basis for defining who is an 'insider' for the purposes of insider trading legislation.[29] These principles look to the fiduciary status of the insider and to his possession of informational advantages respectively.

American authorities as to the application of Rule 10b-5, which prohibits deceptive conduct in relation to a securities transaction, have articulated both principles, without always distinguishing between them. The S.E.C. determination in *Cady Roberts & Co* related to a broker's trading on behalf of discretionary accounts using inside information which he received from his partner, who was a director of the corporation the shares of which were traded. The S.E.C. relied on fiduciary principles in referring to the existence of a relationship giving access to information which could be used only for corporate purposes and 'not for the personal benefit of anyone', and at the same time relied on the 'inherent unfairness' of the insider trading with information 'knowing that it is unavailable to those with whom he is dealing'.[30]

American decisions after *Cady Roberts & Co* placed increased emphasis upon inequalities of information. In *S.E.C. v. Texas Gulf Sulphur Co.*,[31] directors and officers of a mining company were held liable for profits made as a result of trading on undisclosed information as to a discovery of mineral deposits. The court held that the trading by company directors and officers was contrary to the policy of Rule 10b-5 that investors on impersonal securities exchanges should have equal access to information, observing that Rule 10b-5

> is based in policy on the justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to information.[32]

The emphasis upon inequality of information was again evident in *Shapiro v. Merrill Lynch, Pierce, Fenner & Smith Inc.*,[33] where the Court observed that the intention of Rule 10b-5 was to secure 'fair dealings in the securities markets' and to 'prevent corporate insiders and their tippees from taking unfair advantage of . . . uninformed outsiders.'

Recent decisions of the United States Supreme Court have restricted the application of insider trading prohibitions to persons subject to existing fiduciary

29 Anisman, *op. cit.* 11.

30 40 S.E.C. 907 (1961), 912.

31 401 F 2d 833 (1968); Skoyles, K. J., 'The Fiduciary Basis of Insider Trading Liability: *Dirks* Down Under?' (1984) *Companies and Securities Law Journal*, 13, 14.

32 *S.E.C. v. Texas Gulf Sulphur Co.*, *ibid.* 848. The Court also approved the formulation in *Cady Roberts* cited above, text to n. 30.

33 495 F 2d 228 (1974), 235.

duties, arising from a prior relationship between the parties. The Supreme Court in *U.S. v. Chiarella*[34] rejected the argument that Rule 10b-5 was breached simply by trading with an unavoidable information advantage over others.[35] The majority held that the defendant was not liable absent the breach of a 'relationship of trust and confidence' owed to those with whom he traded, although leaving open the possibility of liability on the alternative basis of misappropriation of corporate information.[36] This reasoning was followed in *Dirks v. S.E.C.*, which further required that the fiduciary's breach of duty was for his personal benefit.[37] In adopting purely fiduciary reasoning, the majority in *Dirks* failed to address the question of the advantage available to the insider in trading with information not available in the market, although the trade is not for selfish motives.[38]

The 'misappropriation' approach

While American decisions thus indicate a lessened willingness to find breach of Rule 10b-5 to have been established on the basis of inequalities of information, there is substantial support in American decisions for the view that breach of the rule may arise from an insider's 'misappropriation' of the information on which he trades, even where he is under no fiduciary obligation either to the company the shares of which are traded, or to the other party to the trade.[39]

The decision in *Chiarella*[40] left such an approach open, as noted above, although the majority held that it was not available to found a conviction in that case since it had not been put to the jury at trial (at 236). Burger C. J. (dissenting) took the view that Chiarella's conviction could have been affirmed on the ground that he had misappropriated information which his employer had entrusted to him under an obligation of confidentiality (at 245). Brennan J. (concurring) observed that Section 10(b) of the Securities Exchange Act would be violated where a person improperly obtained nonpublic information and used that information in trading in securities (at 239). Blackmun J. (with whom Marshall J. agreed) dissented and would have upheld the conviction on the basis that Chiarella had misappropriated information obtained in the course of his employment, that conduct in his Honour's view being evidence of fraud (at 246).

The 'misappropriation' approach was subsequently adopted in intermediate appellate court decisions,[41] most recently in the decision of the United States

[34] 588 F 2d 1358 (1980) (Court of Appeal); 445 U.S. 222 (1980) (Supreme Court). On *Chiarella*, see Langevoort, D. C., 'Insider Trading and the Fiduciary Principle: A Post-*Chiarella* Restatement' (1982) 70 *California Law Review* 1; Easterbrook, *op. cit.*, 321.

[35] 445 U.S. 222 (1980), 233.

[36] *Ibid.* 228-230. The quotation is at 230. As to the 'misappropriation' approach, see text to note 39, *infra*.

[37] 681 F 2d 824 (Court of Appeal, 1982); 463 U.S. 646 (Supreme Court, 1983) especially 657-8.

[38] Anisman, *op. cit.* 55.

[39] One American commentator has noted that the effect of such an approach is to hold that Rule 10b-5 is violated 'if an individual trades securities on the basis of nonpublic information entrusted with the expectation that it will be held in confidence, regardless of whether the individual is a corporate insider, or whether there exists a breach of duty to the buyers or sellers of the securities': Boinski, S. A., 'Securities Regulation — Newspaper Reporter's Trading on basis of Misappropriated Prepublication Information as Rule 10b-5 Violation' (1987) 60 *Temple Law Quarterly* 215, 216.

[40] 445 U.S. 222 (1980).

[41] *U.S. v. Newman* 664 F. 2d 12 (1981); *S.E.C. v. Materia* 745 F. 2d 197 (1984).

Court of Appeals for the Second Circuit in *U.S. v. Carpenter*.[42] In each of these decisions, breach of Rule 10b-5 was held to have been established on the ground that the employee breached a duty of confidentiality owed to his employer in taking advantage of information obtained in the course of employment by trading in securities. In *Carpenter*, a columnist writing for the *Wall Street Journal* (Winans) had passed information as to the contents and publication dates of his columns to two brokers employed by a large New York broking firm. Those brokers had traded profitably by anticipating the likely market effect of information published in the columns, and had an arrangement to share the profits with Winans.

The Court of Appeals held that both Winans and the brokers had violated Rule 10b-5, and also affirmed their convictions under mail and wire fraud statutes. The majority reasoned that information had been misappropriated by Winans from his employer in breach of a duty of confidence, and that such breach constituted a breach of fiduciary obligation sufficient to ground a violation of Rule 10b-5 under the Supreme Court's approach in *Chiarella*,[43] although Winans was under no prior fiduciary obligation either to the companies the shares of which were traded or to the other parties to the trades (at 1032). Miner J. dissented as to the convictions for securities fraud but not as to the convictions for mail and wire fraud, *inter alia* on the ground that the information misappropriated by Winans was not in the nature of nonpublic 'securities-related' information (at 1036).

The Court of Appeals' decision in *Carpenter* was subsequently appealed to the United States Supreme Court.[44] In a judgment which is in this respect more than a little curious, the Supreme Court observed as to the breach of Section 10b of the Securities Exchange Act 1934 and Rule 10b-5 merely that

> [t]he Court is evenly divided with respect to the convictions under the securities laws and for that reason affirms the judgment below on those counts.[45]

In the absence of any further indication of the Court's view, one must assume that the 'misappropriation' approach is of continued, albeit mysterious, authority in the United States.

The 'misappropriation' approach might be characterised as a product of the particular statutory regime established by Rule 10b-5, and of the attempt by American intermediate appeal courts to avoid the restriction of Rule 10b-5 which appeared to follow from the reasoning in *Chiarella*.[46] The insider's breach of an obligation of confidentiality owed to his employer seems in principle to be a less persuasive justification for prohibiting the insider from trading than either the

[42] 791 F. 2d 1024 (1986). For discussions of the Court of Appeals' reasoning, see *Boinski, op. cit.*; n. 38a; 'Cleaning up the securities markets: have insider trading prosecutions gone too far?' (1987) 16 *Stetson Law Review* 537; Levant, D. B., 'Financial Columnists as Investment Advisers: After *Lowe* and *Carpenter*' (1986) 74 *California Law Review* 2061. The decision of the U.S. Supreme Court on appeal is discussed *infra*.

[43] 445 U.S. 222 (1980).

[44] Decided November 16, 1987. Citations are from the preliminary print of the United States Reports. The Honourable Mr Justice Gummow of the Federal Court of Australia kindly provided the writer with a copy of this judgment.

[45] *Ibid.* 5.

[46] Boinski, *op. cit.* 236.

insider's information advantage as against other participants in the market deriving from the breach, or the 'unfairness' (whatever the definitional difficulty of that concept) of the insider's trading with such an advantage.

Excursus: inside information as property

The 'misappropriation' approach as articulated in American decisions typically assumes the proprietary nature of the information obtained by the insider.[47] Thus the Supreme Court in *Carpenter*,[48] in upholding the convictions of Winans and his associates for mail and wire fraud, characterised the newspaper's right that its columns be held confidential prior to publication as a 'property right', although a right in intangible rather than tangible property. The Court referred to earlier American decisions characterising confidential information as property,[49] and to an academic statement that '[c]onfidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has an exclusive right and benefit'.[50] In a somewhat different context, Hogan equally identifies a prohibition of insider trading on fiduciary grounds with the characterisation of the inside information as property of the company. Thus, in Hogan's view, the fiduciary principle assumes that

> the owners have a property interest in the information held by the company so that those breaching a fiduciary relationship might gain at the expense of the owners, namely shareholders.[51]

The issues raised by a characterisation of inside information as property are closely analogous to those arising in the context of breach of confidence, where it has been recognised that it is the confidential relationship arising in particular circumstances and not any property right in the information which gives rise to the duty to respect confidentiality.[52] Similarly, a fiduciary justification for a prohibition of insider trading must depend upon the special relationship between insider and company or insider and shareholders, rather than upon any proprietary right of the company in the inside information.

The range of beneficiaries of the insider's fiduciary duty

The fiduciary principle requires that the category of persons to whom the duty of good faith is said to be owed is properly delimited. In Australian law, the fiduciary duties of insiders are founded by a pre-existing relationship with

47 It is arguable that such an assumption is not logically necessary to the 'misappropriation' approach, since it is the quality of the misappropriation rather than the characterisation of the misappropriated information which is fundamental.

48 *Supra* n. 44.

49 *International News Service v. Associated Press* 248 U.S. 215 (1948) 236; *Ruckelshaus v. Monsanto Co.* 467 U.S. 986 (1984) 1001ff; *Dirks* 463 U.S. 646 (1983) 653.

50 Fletcher, *Cyclopedia of the Law of Private Corporations* (rev. ed. 1986), Vol. III, 260, also cited in *Dirks*, *supra* n. 37.

51 Hogan, *op. cit.* 40.

52 Meagher, Gummow & Lehane, *Equity: Doctrines & Remedies* (2nd ed. 1984), pars 4116 *et seq*; Stuckey, J. E., 'The Equitable Action for Breach of Confidence: Is Information Property?' (1981) 9 *Sydney Law Review* 402, 432-3. There is U.S. authority which recognises that an obligation of confidence derives from particular relationships, including the employment relationship, so as to impose a 'fiduciary obligation' to protect confidential information obtained in the course of such a relationship: *Snepp v. United States* 444 U.S. 507 (1980), 515.

the company.[53] Company directors and company officers, typically within the scope of insider trading legislation, fit without difficulty within the fiduciary category. It is clear law that a director is fiduciary to his company, and is prohibited from using information acquired as director to benefit himself.[54] Australian courts have been prepared to accept that such fiduciary duties extend to senior employees and restrict the use of confidential information acquired in the course of employment.[55] The restriction arguably extends more widely, to opportunities which are of 'concern' and 'relevance' to the company although arising outside the employee's office, at least where the employee is in full-time employment in a senior position.[56]

The prohibition of insider trading may be supported on a fiduciary basis in that insider trading is inconsistent with the duty of loyalty owed to a company by its officers. There are functional justifications for the application of insider trading prohibitions to company directors and officers. Brudney notes that since insiders are given access to company information 'at the expense of the enterprise, and for the purpose of conducting the business for the collective good of all stockholders', then '[t]here is no reason for them to be entitled to trade for their own benefit on the basis of such information'.[57] Such a prohibition is consistent with the economic justification of fiduciary principles as a means of reducing agency costs by reducing the need for specific contractual limits upon the fiduciary's discretion.[58] The difficulty with extending the fiduciary justification of insider trading regulation to trading with outsiders and to stock exchange transactions will be noted below.

Clearly, directors derive any inside information in consequence of their position of trust in the company. Any such information advantages them as against their beneficiaries,[59] if the beneficiaries of directors' duties are properly taken to be the shareholders in the company. The difficulty with this reasoning is that, while recognising the nature of the fiduciary duty owed by directors to the company, it obscures the unresolved issue in Australian law as to whether that fiduciary duty is owed to the corporate entity only, or extends to individual shareholders. If the directors' fiduciary duties are owed to the corporate entity only, the information advantage gained by a director or officer is not within the scope of duties owed to shareholders.

The traditional position has thus been that directors and company officers owe fiduciary duties to the company itself and not to members of the company.[60] This principle has application to the remedies available to shareholders at general law in insider trading situations, and indeed was established in the leading case of

53 Anisman, *op. cit.* 11.

54 *Regal (Hastings) Limited v. Gulliver* [1967] 2 A.C. 134.

55 *Green and Clara Pty Ltd v. Bestobell Industries Pty Limited* (1982) W.A.R. 1.

56 *Industrial Development Consultants Limited v. Cooley* [1972] 1 WLR 443 *per* Roskill J. 451. On the scope for the adoption of a wider 'corporate opportunity' doctrine in Australia, see Austin, *op. cit.*

57 Brudney, *op. cit.* 343-4.

58 Dooley, *op. cit.* 70; Anderson, A. G., 'Conflicts of Interest: Efficiency, Fairness and Corporate Structure' (1978) 25 *U.C.L.A. Law Review* 738, 758-61; Langevoort, *op. cit.* 6.

59 Anisman, *op. cit.* 15.

60 Rider, *op. cit.* 91.

Percival v. Wright[61] where directors purchased shares from shareholders having special knowledge of negotiations as to the future of the company. Its effect has been taken to be that, in the absence of fraud and in the absence of a fiduciary relationship arising on other grounds, a director need not account to a shareholder with whom he trades while in possession of inside information.[62]

The approach of the majority of American states, by contrast, has been to hold that a fiduciary obligation of disclosure by directors and company officers arises when there exist 'special facts' distinguishing the dealings of director and shareholders from arm's length dealings. These 'special facts' may arise from the insider's position, his special knowledge of the company, or from the nature of his dealings with shareholders.[63] Where such 'special facts' exist, the director or company officer cannot purchase or sell shares from other shareholders without revealing 'material' and nonpublic information which makes the shares more or less valuable than the other shareholder would believe on the basis of publicly available information.

The New Zealand decision in *Coleman v. Myers*[64] supports a possibly slightly narrower version of the American 'special facts' doctrine. At first instance, Mahon J. held that where the directors of a company were entrusted with management, then in any transaction between director and shareholder a director was a fiduciary as to information affecting the value of shares,[65] and would be required to disclose any fact which the director is aware is not known to the shareholder and 'which might reasonably and objectively control or influence' the shareholder's judgment.[66] The Court of Appeal took a less expansive view than Mahon J., but nonetheless held that previous dealings between directors and shareholders had on the facts established a relationship of trust. It may be that the reasoning in the Court of Appeal is limited to circumstances establishing a special reliance by other shareholders on the judgment of the directors.[67] In the writer's view, the decision does not establish that the special character of the inside information possessed by directors will itself give rise to a fiduciary duty to shareholders, in the absence of other circumstances importing a fiduciary quality in the dealings of directors and shareholders.

Recent authorities suggest that Australian courts may be sympathetic to a wider view of the scope of directors' duties.[68] There is authority that in some circumstances a company's directors must take into account the interests of the company's creditors,[69] while it appears that directors of a trading trust may also

61 [1902] 1 Ch. 421.

62 Skoyles, *op. cit.* 14.

63 *Strong v. Repide* 213 U.S. 419 (1909); Loss, L., *Fundamentals of Securities Regulation* (1983), 818-9; Langevoort, *op. cit.* 5. Anisman, *op. cit.* 2-3 characterises the 'special facts' doctrine too narrowly, as arising where '"special facts" exist affecting the value of the shares'. On American authorities, the special facts at issue are those of the transaction between director and shareholder, and not merely the worth of the shares.

64 [1977] 2 N.Z.L.R. 225 (Mahon J.), [1977] 2 N.Z.L.R. 298 (Court of Appeal). For discussion of this decision, Rider, *op. cit.* 98-100.

65 *Ibid. per* Mahon J., 277-8.

66 *Ibid.* 278.

67 Anisman, *op. cit.* 3.

68 Heydon, J.D., 'Directors' Duties and the Company's Interests' in Finn, *op. cit.* 120-36.

69 *Walker v. Winborne* (1976) 137 C.L.R. 1; *Nicholson v. Permakraft (N.Z.) Limited (in liq.)* (1985) 3 A.C.L.C. 453; *Kinsela v. Russell Kinsela Pty Limited (in liq.)* (1986) 4 A.C.L.C. 215.

in some situations owe a duty to the beneficiaries of the trust.[70] There are indications in recent cases as to notice of meetings that Australian courts are prepared to recognise an obligation of directors to act fairly toward shareholders. In *Deveraux Holdings Pty Limited v. Pelsart Resources NL*,[71] Young J. treated the obligation not to mislead the shareholders by 'providing them with material that is other than substantially full and true' as associated with the directors' duty to the company. Similarly, in *Chequepoint Securities Limited v. Claremont Petroleum NL*[72] McLelland J. held that the fiduciary obligations of directors to the company required that they disclose to shareholders any benefits to be received from a proposed resolution, and make 'a full and fair disclosure of all matters within their knowledge which would enable the members to make a properly informed judgment'. The reasoning in these cases suggests that, although the directors' duties are owed to the corporate entity, such duties may give rise to associated obligations towards shareholders. While such reasoning does not establish a separate right of action against directors and company officers in relation to insider trading, it allows conceptual support for a fiduciary approach to insider trading.

Nonetheless there are few indications that Australian courts are likely to treat *Percival v. Wright* as no longer authoritative. The decision in *Percival v. Wright* was followed in *Esplanade Holdings Pty Limited v. Divine Holdings Pty Limited.*[73] It should be noted, however, that in *Hooker Investments Pty Limited v. Baring Bros Halkerston*[74] Young J. suggested, in wide overstatement, that '*Percival v. Wright* has virtually been discarded by more modern thinking'. The Court of Appeal in *Hooker Investments* did not comment upon his Honour's account of modernism.

To the extent that the circumstances in which the common law will allow liability for insider trading are closely confined in Australia, the operation of the legislative scheme is of greater significance. The application of the fiduciary principle to insider trading by company officers is given statutory expression in section 229(3) of the Companies Code, which focuses upon the advantage gained by a company officer or the detriment to the company caused by 'improper' use of company information.[75] Since section 128 applies to a wider range of insiders, and is directed in underlying policy to the effect of insider trading in the market, in the writer's view the conjoint operation of section 229(3) and insider trading legislation is justified.

The fiduciary principle and impersonal markets

English and Australian cases as to fiduciary obligations of directors trading with shareholders have typically involved direct transactions, in the context of

[70] *Hurley v. BGH Nominees* (1982) 1 A.C.L.C. 387.

[71] (1986) 4 A.C.L.C. 12, 14. See also *Bancorp Investments Limited v. Primac Holdings Limited* (1985) 3 A.C.L.C. 69.

[72] (1986) 4 A.C.L.C. 711, 713.

[73] (1980) 4 A.C.L.R. 826.

[74] (1986) 10 A.C.L.R. 462, 463.

[75] Ryan, *op. cit.* 13, 27. The term 'improper' here is of uncertain reach. As to the scope of section 124(2) of the Uniform Companies Act 1961, see *Commissioner for Corporate Affairs (Victoria) v. Green* [1978] V.R. 505.

'closely held' companies. The justification of the prohibition of insider trading upon fiduciary principles, based on the previous dealings of the parties with each other, is not readily applicable to transactions between insiders and persons not already shareholders.[76] Such transactions are of course the norm in the trading of securities in public securities markets.

In dealing on a stock exchange, purchasers and sellers of shares typically deal on the basis of market information without particular knowledge of the other party to the transaction. Even in the absence of insider trading, available market information may not accurately reflect the underlying value of the securities, since for commercial reasons information will frequently not be revealed to the market.[77] It is a consequence of the nature of an exchange-based transaction that the buying or selling insider will rarely have induced the other party to trade, while the fact that a trade occurs with an insider rather than with other persons in the market at the same time is essentially random. That the insider has inside information has no direct effect upon the price at which the transaction occurs, and upon any consequent loss to the other party,[78] although obviously if that information were publicly known it might impact on the willingness of the other party to continue with the transaction. Other traders on the market are not themselves beneficiaries of any fiduciary duty owed by the insider, whether to the company or its shareholders.

In the intermediate situation, where a transaction as to shares in a listed company takes place off-market, the insider and the other party are more likely to deal directly, and the insider's conduct is more likely to induce the other party to trade. It remains that the previous relationship necessary to establish a fiduciary duty will typically be absent. The fact that an insider takes advantage of inside information in a single off-market transaction, taking place at arms's length, does not in itself establish any fiduciary obligations between the insider and the other party to the transaction.[79]

In American law, notwithstanding the differences between face-to-face transactions and market transactions, the application of Rule 10b-5 has been extended to insider dealing in impersonal markets. As noted above, the reasoning behind such extension is that the information upon which the insider trades is available to him only for a corporate purpose, and that it is inherently unfair that the insider should trade on that information without disclosing it to the market.[80] Such reasoning extends the insider's duty of loyalty to the company to found a duty to persons trading in the share market. It is not obvious that the former is either a prerequisite to or a logical basis for the latter.

In the Issues Paper prepared for the National Companies and Securities Commission, Anisman adopted somewhat different reasoning in arguing that there is in fact a causal connection between an insider's trading and the other party's loss

[76] Rider, *op. cit.* 99-100.
[77] Langevoort, *op. cit.* 18.
[78] Anisman, *op. cit.* 4, 102; Hogan, *op. cit.* 48.
[79] *Cf. Tito v. Waddell (No 2)* [1977] Ch. 106 *per* Megarry V.C. at 230, rejecting the suggestion that 'one can take a person who is subject to no preexisting fiduciary duty and then say that because he self deals he is thereupon subjected to a fiduciary duty'.
[80] *Cady, Roberts & Co*, 40 S.E.C. 907 (1961); Langevoort, *op. cit.* 8.

even in trading in public securities markets, since traders in the market can reasonably expect that 'no fiduciary is silently trading on the basis of undisclosed price sensitive information', with the result that 'reliance on the insider's legal obligation to disclose can be said to induce the shareholder to trade'.[81] Anisman's argument appears in effect to be that insider trading should be prohibited given that investors assume that it will not occur. The suggestion that investors expect that no fiduciary will be trading depends upon the market's assuming that insider trading is unacceptable, and does not independently substantiate such assumption.

The 'access to information' approach

The regulation of insider trading has been justified not only upon fiduciary principles, but also upon a principle of equal access to information. Indeed, Anisman's Issues Paper suggested that equality of access to information should be the dominant principle in a market context.[82] The 'access to information' approach has substantial attractions, allowing a logical basis for extending the prohibition of insider trading to several categories of persons who on policy grounds would appear to be within the proper scope of such prohibition, but who fall outside the fiduciary category.

The 'access to information' principle, originating in the work of Brudney[83], suggests that investors in a market should have an equal opportunity to obtain and evaluate information relevant to trading decisions. Since the argument emphasises the opportunity to obtain information, it allows that an investor who has obtained information through research or analysis is entitled to take advantage of that information where others in the market could have obtained that information given equal effort.[84] On Brudney's account, trading on inside information is objectionable — by contrast with trading on the basis of information acquired by search — in that it denies the other party the opportunity to lawfully overcome the information advantage of the insider.[85]

Anisman adopted a similar approach, distinguishing insider information from information resulting from search and analysis by the relative absence of market risk in insider trading.[86] Thus, regulation of insider trading based upon a principle of equal access to information would address the market risk of individual traders, with effect that

> information obtained through a position or relationship with a company or in the market which, because it is not available to others, enables a person to engage in essentially riskless transactions in securities is usually sufficient to disentitle him from trading.[87]

Anisman's reasoning here has been the subject of criticism. A Committee established by the Securities Institute of Australia denied that transactions under-

81 Anisman, *op. cit.* 4.
82 *Ibid.* 13.
83 Brudney, *op. cit.*
84 *Ibid.* 341-2; Heller, H., '*Chiarella*, S.E.C. Rule 14e-3 and *Dirks*: "Fairness" versus Economic Theory' (1982) 37 *Business Lawyer* 517, 529.
85 Brudney, *op. cit.* 355, 360.
86 Anisman, *op. cit.* 12.
87 *Ibid.* 13.

taken by an insider were necessarily riskless, pointing to uncertainties arising from the information itself and from doubt as to market reaction when the information became public.[88] Clearly, the insider's choice of trading strategy will involve risk to the extent that it requires the interpretation of the information he possesses. These observations are supported by Hogan's account of American evidence that the possession of inside information does not necessarily give rise to profitable trading outcomes.[89] Allowing that there may be no such thing as an absolutely riskless transaction, it remains that the possession of material price-sensitive information by an insider typically reduces his risk as against his situation if he had no such information, and advantages him against the other party with whom he trades while the other party lacks the information.

Further, the Securities Institute Committee suggested that Anisman's definition of 'material information' would include information 'upon which it would be extremely risky to act', and asserted that 'it is inappropriate that trading upon the basis of such information should be regarded as insider trading'.[90] One might question here whether the high degree of risk attached to particular inside information denies the materiality of such information to investment decisions. Where high-risk information raised the possibility of substantial profit or loss for the company the shares of which are being traded, then such information may well affect an individual investor's decision as to whether to trade, and may materially affect the price at which the company's shares would be traded. Clearly, an investor may on occasion choose to act in a 'risky' transaction in the expectation of an appropriate risk premium in his profit from the transaction. The insider who has access to inside information and chooses to act upon it although the transaction involves a high degree of risk is advantaged against investors who trade without access to the information. It is therefore difficult to accept the Committee's assertion that 'it is unclear that an "advantage" has been obtained where the decision was a risky one — notwithstanding possession of inside information'.[91]

The fact that in most cases the possession of information derived from insider status and not publicly available leads to a lessening of risk even in the high-risk transaction is sufficient on prophylactic grounds to extend the prohibition on insider trading to all cases, even if the insider's absolute risk in the transaction is high. That information obtained by an insider may on occasion be misleading does not question a prohibition adopted on such grounds.

The scope of the 'insider' category

The 'access to information' approach suggests that several categories of trader ought to be included within the insider trading prohibition although they are not within a fiduciary relationship with the company. A substantial shareholder is not in Australian law a fiduciary of the company in which he holds shares,[92]

88 'Trading on the Inside', *op. cit.* 7.
89 Hogan, *op. cit.* 47.
90 'Trading on the Inside', *op. cit.* 7.
91 *Ibid.*
92 *Burland v. Earle* [1902] A.C. 83; Rider, *op. cit.* 85-6.

although in practice he is likely to be able to obtain information about the company which is not available to minority shareholders or to the market. Since the fiduciary category depends upon a pre-existing relationship with the company or its insiders, an offeror in a takeover will typically fall outside that category although in possession of price-sensitive information about the company's shares.[93] The principle of 'access to information' suggests that both substantial shareholders and offerors should be categorised as 'insiders' for the purpose of the prohibition upon insider trading.

Section 128(1) applies to persons who are defined insiders of a company, prohibiting a person who has the requisite connection with a body corporate dealing in any securities of that body corporate if by reason of his connection 'he is in possession of information that is not generally available but, if it were, would be likely materially to affect the price of those securities'. Section 128(2) prohibits a person connected with one company from dealing in the securities of another body corporate where he has had access to information which is not generally available but is likely materially to affect the price of those securities, and which 'relates to any transaction (actual or expected) involving both those bodies corporate or involving one of them and the securities of the other'.

Section 128(8) specifies certain circumstances in which a person will be connected with a body corporate, having effect that a person is so connected if he is an officer of that body corporate or a related body corporate, a substantial shareholder in that body corporate or a related body corporate, or is within a professional or business relationship with the company or is an officer of a substantial shareholder in the company or a related company. Following the decision of the Court of Appeal in *Hooker Investments Pty Limited v. Baring Bros Halkerston*,[94] it appears that sections 128(1) and 128(2) apply to natural persons connected with the company under the definition in section 128(8). Section 128(3) then applies to natural persons who receive information from persons within the scope of sections 128(1) and 128(2).

Where a takeover bid is proposed, insiders of the intending bidder are caught by the present section 128, although (by contrast with Anisman's proposals[95]) the section does not operate by deeming insiders of the bidder as insiders of the target. Where a natural person is connected with the offeror under section 128(8), and by reason of that connection is in possession of information relating to the takeover bid which would, if it were generally available, materially affect the price of shares in the target, then that information relates to an expected transaction involving both bidder and target and the person is prohibited under section 128(2) from dealing in the shares of the target.[96] The prohibition of insiders of the takeover bidder dealing in shares of the target is clearly justified on 'access to information' reasoning, although it lies outside the scope of a

93 Anisman, *op. cit.* 11.

94 (1986) 10 A.C.L.R. 524; (1986) 5 N.S.W.L.R. 157 (Court of Appeal) *per* McHugh J. 527-8; 162. As to the facts in *Hooker Investments*, see text to n. 17, *infra*.

95 Under Anisman's proposals, where a takeover bid was proposed, insiders of the intending bidder were to be treated as insiders of the proposed target (paragraph 1(3)). That Anisman's proposal substantially extended section 128 is doubtful.

96 Ryan, *op. cit.*, 19; Halstead, *op. cit.* 2.

fiduciary justification for insider trading regulation, since officers of the bidder would not be under fiduciary obligations to those with whom the company deals.[97]

It has to be noted, moreover, that fiduciary and access to information reasoning lead to different results as to the identification of the person suffering loss where an officer of a bidder trades in a takeover setting. On fiduciary reasoning, the officer's duty is owed to the bidder, and the officer ought to be held accountable to the bidder for any profit made on his trading, or alternatively to compensate the bidder for any loss suffered by the bidder by the increase of the market price of the shares following the officer's trading. By contrast, on access to information grounds the persons suffering loss where an officer of the bidder trades are the other parties to the trades, or more widely all investors trading in the market at the time of the trades. Section 130(1)(c) of the Code allows the narrower remedy, requiring the officer of a bidder trading in breach of section 128(2) to compensate the other party to the transaction for any loss sustained by that party by any difference between the price at which the shares were traded and the price at which they would have been traded had the information been generally available.

Section 130(1)(d) further provides for the officer of the bidder to account for any profits to the body corporate that issued the shares, that is the target company. The latter result is difficult to reconcile with either fiduciary or access to information principles, where the officer owes no duty to the target, and any increase in the price of shares on the market will disadvantage the bidder and not the target. Although an accounting to the target company benefits its shareholders as a whole, there is no reason to assume that such shareholders would necessarily have been disadvantaged by the officer's trading.

The nature of 'inside' information

Under sections 128(1) and 128(2) of the Code, the essential elements of 'inside' information — the possession of which will place the insider under the prohibition of trading — are its not being generally available,[98] and its being likely to materially affect the price of the securities if it were available. The test that the inside information would have a 'material' effect upon the price of the securities probably requires a substantial or significant effect.

In determining whether information was sufficiently material to fall within the 'disclose or abstain' principle under Rule 10b-5, the American courts have generally required that the information have a relatively high probability of occurrence, and that it be of a kind that would affect the decision of a reasonable investor as to whether to retain or to trade securities. The fundamental issue under such a test is 'the influence of data on investor decision making'.[99]

Prior to the enactment of the Securities Industry Code, New South Wales courts had taken a relatively narrow view of the kind of information which might

97 Anisman, *op. cit.* 11.
98 *Ibid.* 74.
99 *Ibid.* 92; Heller, *op. cit.*, 526-7; *S.E.C. v. Texas Gulf Sulphur Company*, 401 F 2d 833 (1968) 849; *S.E.C. v. Monarch Fund* 608 F. 2d 938 (1979), 942; *U.S. v. Chiarella*, 445 U.S. 222 (1980)

be 'material' to an investor's trading decisions. In *Ryan v. Triguboff*,[1] with respect to section 75A of the Securities Industry Act 1970 (NSW) the Court held that 'specific information' must be capable of being identified, and cannot be created by a deductive process. The authority of that case is limited by the subsequent omission of the requirement that information be 'specific' from section 128.

A wider view of the nature of 'material' information was taken in Victoria in *Corporate Affairs Commission v. Green.*[2] In *Hooker Investments*,[3] Young J. followed the reasoning in *Green* in observing that information would include 'factual knowledge of a concrete kind or that obtained by means of a hint or veiled suggestion from which one can impute other knowledge', allowing further that the category of 'information' may be broader than the category of 'knowledge'.[4]

In the Court of Appeal in *Hooker Investments*, McHugh J. observed that the 'materiality' of information under section 128 was class-specific, with effect that '[p]ossession of information likely to affect the price of one or more securities of a body corporate does not preclude the possessor from dealing in other securities of that body corporate'.[5] His Honour's reasoning is plausible so long as the test of materiality is based on the effect of information on the market price of securities rather than on investor judgment. However, were the test of materiality to be shifted to relevance to investor decision-making, then it is arguable that information as to one class of securities might in some circumstances be regarded by the reasonable investor as important for his investment decisions as to other classes.

Anisman rightly observed that the definition of the 'materiality' of information functions as a threshold for the application of the prohibitions upon trading and tipping.[6] The more rigorous the standard of 'materiality' — that is, the more certainty and specificity required of undisclosed information before it is treated as 'material' — the more likely that insider trading will in fact take place in the market based in rumour and communicated suggestions of possible trading outcomes.[7]

Anisman suggested a change in approach to the definition of the materiality of insider information, arguing that the differentiation between 'material' and non-material information should take into account both the advantage to the insider in possessing particular information and the extent to which that information reduces or excludes risk in his trading.[8] On this approach, a test of materiality

> must distinguish between facts which while giving their possessor an advantage over others who are ignorant of them are not sufficiently important to warrant exclusion from the market pending their disclosure from the market and those which are.[9]

[1] [1976] 1 N.S.W.L.R. 588. A substantially similar view was taken in Canada in *Green v. Charterhouse Group Canada Limited* (1973) 35 D.L.R. 3d 161, (1976) 68 D.L.R. 3d 592 (Court of Appeal).
[2] [1978] V.R. 505.
[3] (1986) 10 A.C.L.R. 462.
[4] *Ibid. per* Young J., 467-468.
[5] (1986) 10 A.C.L.R. 524, 528; (1986) 5 N.S.W.L.R. 157, 162.
[6] Anisman, *op. cit.* 91.
[7] Heller, *op. cit.*, 531.
[8] Anisman, *op. cit.* 92 and note 627.
[9] *Ibid.* 91.

Anisman argued that price-sensitive information should be held to be 'material' when a reasonable person would attach importance to that information in reaching decisions as to a securities transaction in the particular circumstances.[10] This test might be characterised as an objective investor judgment standard, by contrast with the price effect standard under section 128. As Anisman recognised, the standard of materiality under section 128 and the standard under his proposals both require 'a judgment on the nature of the advantage obtained by an insider and whether investors required the confidential information to make a reasonable investment decision'.[11] The information to which a reasonable person would attach importance in deciding whether to purchase or sell securities is generally likely to be information which would have an effect on the market price of the securities, and would therefore be 'likely materially to affect the price of those securities' under sections 128(1) and 128(2).[12] The effect of a shift from a standard of material effect upon price to a standard based on the relevance of information to the reasonable investor's decision-making might however have been significant in a minority of cases, since information may conceivably be 'material' to a reasonable man's investment decisions while not sufficiently important to bring about a 'material' change in the price of the securities.

The most significant consequence of a shift to an investor judgment standard would have been procedural in nature. The National Companies and Securities Commission has taken the view that establishing the 'materiality' of information under section 128 would require expert evidence as to the effect of the information in the securities market.[13] By contrast, the question of the importance which a reasonable man would attach to information in reaching a decision as to the sale or purchase of securities formulates the issue of materiality as a matter for the judgment of the Court.

An alternative limit upon the nature of information to be treated as material was suggested in the Submission of the Securities Institute of Australia to the N.C.S.C., in recommending that materiality should depend upon the amount of information which a reasonable person would consider material, but that it should also be required that the insider gained a 'significant advantage'.[14] If the latter requirement excludes liability of the insider where he gains little advantage, then it might be suggested that an insider who trades on inside information in the expectation of profit but fails to achieve any substantial gain is not therefore less culpable, but merely less successful. The decision whether enforcement proceedings are justified where the insider's gains are small[15] should be made on a case-by-case basis, rather than by placing such a limit in the definition of materiality.

[10] In Anisman's legislative proposals 'material information' is defined as 'information to which a reasonable person would attach importance under the circumstances in determining to purchase or sell securities': paragraph 1(1)(f)).
[11] Anisman, *op. cit.* 93.
[12] Halstead, *op. cit.* 7.
[13] Ibid. 8.
[14] 'Trading on the Inside', *op. cit.* 7.
[15] *Ibid.*

A further question to be considered in determining the nature of information which will fall within an insider trading prohibition is whether 'inside' information is restricted to confidential information of a company — known to company officers as a result of their relationship with the company, and intended to be used for company purposes[16] — or whether it extends to 'market' information. The former view follows from the fiduciary approach to insider trading legislation, while the latter approach finds justification on an 'access to information' principle.[17] Section 128 adopts the latter approach in that the prohibition upon insider trading under sections 128(1) and 128(2) will apply to a person with the requisite connection with the company who is in possession of price-sensitive information although that information did not originate with the company. The extension of the prohibition upon insider trading to market information reaching an insider other than as a result of his relationship with the company may be justified on prophylactic grounds, since absent such an extension it would be difficult to 'polic[e] the evanescent line which separates information obtained as insider and information not so obtained'.[18]

It should be noted that the present section 128 requires no improper motive by the insider, and therefore the insider may not avoid liability 'by showing that his motive was not personal profit or some other reprehensible end'.[19] On fiduciary principles, the fact that an insider has not behaved in breach of duty or made a profit at the expense of the company is a persuasive justification for his avoiding liability. On an 'access to information' approach, however, the fact that an insider may not intend to profit personally from trading does not deny his legally unerodable information advantage over other traders in the market, and he ought therefore to be held within the scope of the prohibition upon insider trading.

Public availability of information

It is, of course, fundamental to the concept of insider trading that the information upon which the insider trades is not generally available to investors in the market, as the decision in *Kinwat Holdings Pty Limited v. Platform Pty Limited*[20] demonstrates. It follows that an insider may avoid insider trading by disclosing the particular information on the basis of which he proposes to trade so allowing others in the market the ability to take account of that information.[21] This principle is adopted in American decisions as to Rule 10b-5 as the 'disclose or abstain' principle. The effect of that principle, given an insider's duties to his company, will typically be to 'prohibit an insider from trading until the company releases the information to the public'.[22] Disclosure may be unacceptable to the company for legitimate commercial reasons, where for example it would place a transaction at risk by allowing competitors access to the company's intentions, or place

16 Anisman, *op. cit.* 90-1; Heller, *op. cit.*, 522-3.
17 *Ibid.* 90-1.
18 Brudney, *op. cit.* 346.
19 Anisman, *op. cit.* 57.
20 (1982) 1 A.C.L.C. 194.
21 Prentice, *op. cit.*, 94-5; Brudney, *op. cit.* 348.
22 Anisman, *op. cit.* n. 349.

the company at a negotiating disadvantage as against the other party to a transaction.[23]

As interpreted in *S.E.C. v. Texas Gulf Sulphur Company*,[24] the disclose or abstain rule requires that the insider refrain from trading for some time after the disclosure of information so as to prevent him gaining a headstart in the period required for the assimilation of that information by the market. Trading between an insider and others following such assimilation involves no violation of the 'access to information' principle, both because each investor in the market will have the ability to take the information into account, and because in any case on the 'efficient capital market' hypothesis the market price of the shares will reflect the effect in the market of the release of that information.[25]

The prohibition against an insider trading immediately after the release of information to the market has been criticised. Hogan argues that such a prohibition merely changes the order in which investors trade following the release of information, since insiders within its scope are unable 'to trade the relevant securities for, say, a couple of days, but alert "outsiders" would be able to trade immediately.'[26] If, on the weaker version of the efficient market hypothesis, there is a period of time between release of the information and its absorption in the market during which abnormal trading returns may be achieved,[27] then the effect of prohibiting the insider from trading immediately following public disclosure is to secure those profits to the 'alert "outsider" '.

This is, in the writer's view, an outcome which is acceptable, and not the less so because the 'alert "outsider" ' profits from a trading window as against the insider. The disadvantage to the insider, who is restricted from trading in a particular security in a period when outsiders are not so restricted, has prophylactic justification. On the fiduciary principle, it is an appropriate result that any abnormal profit be achieved by outsiders rather than insiders, since trading by an 'alert "outsider" ' involves no breach of duty either to the company the shares of which are traded or to its shareholders.

It should be noted that section 128 does not attempt to specify the appropriate waiting period after release of information before an insider may commence to trade on the basis that the information is publicly available, or the means of publication necessary to secure such public availability.[28] The failure to specify a particular period as the minimum required for market absorption has costs in certainty, but may be justified as better able to provide for the different periods which the market will require to absorb information in particular circumstances, and as encouraging the insider to err towards caution in determining when he

[23] Note (1974) *Harvard Law Review* 396, 404.
[24] *Supra* n. 31, 848; *Cady Roberts & Co.*, 40 S.E.C. 907, 912.
[25] Anisman, *op. cit.* 74.
[26] Hogan, *op. cit.* 47
[27] *Ibid.* 48.
[28] *cf.* Anisman's proposed legislation, which in paragraph 1(1)(g) defined 'public information' so as to secure a waiting period after 'material confidential information' was made public before an insider could trade on such information, requiring both that the information had been disclosed by a filing, a press release or 'another form of publicity that is likely to bring it to the attention of a reasonable investor', and that 'a reasonable time for it to be generally disseminated to investors ha[d] expired'.

may commence to trade. The effect of section 128(10), allowing a defence to the insider where 'the other party to the transaction knows, or ought reasonably to have known, of the information before entering into the transaction', is that disclosure of inside information to the market as a whole may not be required to avoid liability. While avoiding unfairness as between the parties to the transaction, disclosure limited to the other party to the transaction will often not satisfy the policy objective of informing the market as a whole.

Transactions amounting to insider trading

The decisions in *Hooker Investments*[29] are authority as to the application of section 128 in situations other than trading of issued shares on the Stock Exchange. In that case, the plaintiff sought to restrain a proposed issue of shares on the ground that the underwriter and the institutions with whom the shares were to be placed had been in possession of profit forecasts of the company at the time of entering into the underwriting agreement, which were argued to be 'price-sensitive' information not generally known in the market.

Young J. at first instance held that section 128 focused upon transactions between an insider and another in which information available to the insider may affect the price of what is traded.[30] His Honour concluded that the prohibition in section 128(1)(a) did not import the extended definition of 'securities' in section 5(4) of the Companies Code, and therefore did not extend to the issue of shares. Significantly, his Honour reviewed the function of section 128 within the scheme of securities regulation. He suggested that the Securities Industry Code 'was intended to give rights to people who were outsiders who were dealing with people who were insiders', and observed that the location of section 128 in Part IX of the Code, dealing generally with fraudulent market practices, suggested that it is

> directed to people who are trading in the marketplace and are involving themselves in a transaction where a price could be affected by information and the purpose of the Act is to prevent one person having an unfair advantage from another.[31]

In the Court of Appeal, McHugh J. approved Young J.'s remarks as to the focus of section 128 upon inequalities of information in market dealings, concluding that the section is addressed to 'people who are trading in the market place and is not directed to an underwriting agreement to subscribe for shares proposed to be issued'.[32] On practical grounds, that conclusion seems unavoidable: as McHugh J. observed, to hold otherwise would have prevented companies entering underwriting agreements in circumstances falling outside section 128(7).[33] Moreover, if legislative regulation of insider trading is justified by a need to avoid the use of illegitimate information advantages, then liability should require the use or potential use of that informational advantage in a dealing between an insider and persons lacking access to the information. There will generally be no such

29 (1986) 10 A.C.L.R. 462 (Young J.); (1986) 10 A.C.L.R. 524, (1986) 5 N.S.W.L.R. 157 (Court of Appeal).

30 (1986) 10 A.C.L.R. 462; Halstead, *op. cit.* 5.

31 *Ibid. per* Young J., 464.

32 (1986) 10 A.C.L.R. 524, 529; (1986) 5 N.S.W.L.R. 157, 163.

33 *Ibid.* 530; 164.

inequality of information between company and underwriter in negotiating an underwriting agreement for a new issue of shares.

To the extent that legislative prohibitions of insider trading serve the goals of investor protection in market trading, or of preserving fairness in the market, then the scope of the relevant 'market' must be defined. With the exception of section 128(5), section 128 extends to dealings in both proprietary and listed companies. Anisman proposed that the application of insider trading legislation to both categories of company be retained, and that the prohibition on 'tipping' be extended to proprietary companies.

It can be argued that in a proprietary or unlisted public company there is justification for imposing insider trading regulation in order to preserve the integrity of face-to-face dealings in the shares. The appropriateness of the statutory insider trading regime, with a market orientation, to the negotiated or off-market sale of shares in a proprietary or unlisted company is however not beyond question. It is not self-evident that a negotiated sale between vendor and purchaser is analogous to a sale on a public market, although it has a closer resemblance to 'crossings' or special transactions on the exchange. The purchaser of shares in a negotiated transaction has the ability to take contractual warranties to protect his interests, including warranties as to the disclosure of material facts by the vendor.

The strongest justification for the extension of section 128 to the proprietary and unlisted company is prophylactic, in discouraging unacceptable conduct by vendors, and in reducing agency costs where purchasers may rely upon section 128 and need not on each occasion negotiate warranties as to the disclosure of inside information possessed by the vendor.[34] Further, the proprietary or closely-held public company has been the situation in which liability for insider trading has typically been found on fiduciary grounds.[35] These arguments are not less applicable although in a proprietary company the purchaser will often be an existing shareholder, since a shareholding in a closely-held company does not necessarily allow access to information to which the controllers of the company are privy.

Liability for tipping

Anisman pointed to the usual definition of 'tipping' as involving a '"selective" disclosure of confidential information by an insider or a company'.[36] The substantial objection to tipping, on 'access to information' grounds, is that it provides information advantages for the tippees, by definition creating inequalities of information in the market.[37]

Section 128(5) prohibits a person who is precluded by section 128(1), section 128(2) or section 128(3) from dealing from communicating price-sensitive information to a third party where he 'knows, or ought reasonably to know, that the

34 For this argument applied to the rule against conflict of interest, see Anderson, *op. cit.*
35 Anisman, *op. cit.* 52.
36 *Ibid.* 62.
37 *Ibid.*

other person will make use of that information for the purpose of dealing, or causing or procuring another person to deal in those securities'. Section 128 requires the plaintiff or prosecution to satisfy the Court of each of those elements in order to establish liability of the insider communicating information to another. By contrast, Anisman's proposals for the legislative regulation of tipping[38] were founded on certain presumptions which partly shifted the onus of avoiding liability to the tipper. Anisman argued that an approach based on a mental element as to the materiality of information possessed by a tipper should not be adopted, given the difficulty of proving such knowledge. Rather, '[m]ateriality should be presumed where the insider advises or recommends that another trade, because the advice itself is in this respect equivalent to trading'. Anisman allowed, however, that it should be open to the tipper to show that information was not material by way of defence.[39]

In another respect, Anisman's recommendations as to tipping must surely be uncontroversial, and ought not to be lost in the wider criticisms of his Report. Section 128(5) limits the prohibition on communicating inside information to shares listed on the Exchange, although the prohibition on an insider procuring others to deal in section 128(4) is not so limited. Anisman suggested that the prohibition on tipping should be extended to unlisted public companies and to proprietary companies.[40] This suggestion is justified since the potential for inequalities of information resulting from inside knowledge conveyed to third parties is clearly present in tipping in non-market transactions.

The liability of the tippee

It is necessary to provide in insider trading legislation that a tippee cannot make use of an information advantage which the insider himself would have been prohibited from exploiting. The tippee possessed of price-sensitive information obtains the same information advantage as against others in the market and the same ability to trade at substantially lower market risk as would the insider initially possessed of that information.[41] On 'access to information' reasoning, the tippee's trading is objectionable as a use of material information which is not the consequence of the tippee's research or investigation, allowing an advantage which cannot be eroded by others in the market.[42]

At common law, the liability of a tippee was derivative of the liability of his informant as fiduciary. Where a tippee was aware — although the standard of awareness required has been a matter of continuing uncertainty in the cases —

[38] Under Anisman's proposed legislation, an insider who communicated 'material confidential information' to a third party would prima facie breach the criminal prohibition on communicating information under paragraph 4(2), and be liable to a civil action for breach of paragraph 7(2). In order to establish a defence, the insider would have to show both that 'it was reasonably necessary to inform the other person of the information for purposes of the company's business' (paragraphs 4(8)(a), 7(9)(a)), and that he reasonably believed that the other person would not purchase or sell securities, cause another person to do so or pass on the information to a third party (paragraphs 4(8)(b), 7(9)(b)).

[39] Anisman, *op. cit.* 65.

[40] *Ibid.* 72.

[41] Anisman, *op. cit.* 24.

[42] Brudney, *op. cit.*; Langevoort, *op. cit.* 10.

that information was communicated to him by an insider in breach of fiduciary duty, then the tippee could arguably be required to account on the ground of his having knowingly assisted in the fiduciary's breach of trust.[43]

In American law, the tippee's participation in his informant's breach was held to be the basis of his liability under Rule 10b-5. In *Chiarella*[44], the Court observed that tippees 'have a duty not to profit from the use of inside information that they know or should know came from a corporate insider', and that the liability of the tippee arose 'as participant after the fact in the insider's breach of fiduciary duty'.[45] In *Dirks*[46], the Court followed the logic of the principle that the tippee's liability depends upon the insider's breach, holding that there could be no liability of the tippee where there was no breach of duty by the insider, and in particular where the tipping by the insider was not carried out with the intention of personal gain. It might be doubted whether the prejudice to others in the market or the inequalities of access to information are any the less because the insider allegedly had a proper purpose for breaching the prohibition upon tipping.

An alternative approach, which was adopted in Anisman's proposals[47], is to treat the tippee as though he were himself an insider where he has received material confidential information from an insider and was aware that his informant was an insider. Such an approach has some support in American law prior to *Chiarella*[48] and *Dirks*[49]. In *Shapiro v. Merrill Lynch*[50] the Court held that institutional investors to whom confidential information had been given by underwriters (the underwriters being insiders with respect to the information, which had been provided by the company for the purposes of an issue) 'were subject to the same duties as the traditional insider by virtue of their special access to inside information resulting from their insider contacts'.[51] Such an approach involves a substantial shift from the common law and from section 128 of the Code. In order to regulate the conduct of the tippee, it is not logically necessary nor clearly appropriate in policy to treat him as though he comes under the same duty as the insider, and there may be a benefit in retaining a separate categorisation so as to recognise the source of the tippee's liability in the receipt of information from a person of insider status.

43 *Selangor United Rubber Estates Ltd v. Cradock* [1968] 2 All E.R. 1073, 1123-4; *Karak Rubber Company v. Burden (No. 2)* [1972] 1 W.L.R. 602, 633; *Consul Development Pty Ltd v. D.P.C. Estates Pty Ltd* (1975) 132 C.L.R. 373, especially *per* Stephen J. at 410; *Green and Clara Pty Ltd v. Bestobell Industries Pty Ltd* [1982] W.A.R. 1; Anisman, *op. cit.* 24; Prentice, *op. cit.* 88; Austin, R. P., 'Constructive Trusts' in Finn, P. D. (ed.) *Essays in Equity* (1985) 196-241, especially at 229-40.

44 445 U.S. 222 (1980).

45 *Ibid.* 230.

46 463 U.S. 646 (1983).

47 Paragraph 1(1)(e)(vii) of Anisman's legislative proposals provided that 'a person who is informed of material confidential information by or obtains such information from an insider', and who 'knows that the informant is an insider', is himself an insider. Anisman's proposals did not require that the tippee was aware that communication of the information by the insider was in breach of the insider's duty.

48 445 U.S. 222 (1980).

49 463 U.S. 646 (1983).

50 495 F. 2d 228 (1974).

51 *Ibid.* 237.

The liability of tippees is presently governed by section 128(3),which treats the tippee as within a separate category rather than assimilating him to the position of the insider from whom he obtains his information. The effect of that section is that a tippee who deals in securities is liable only when, at the time he receives price-sensitive information from a person who is prohibited from dealing in the securities, there existed an association with the insider who provided the information or an arrangement for the communication of that information with a view to dealing in securities.

The present section 128 is not wholly satisfactory. In particular, the requirement in section 128(3) that there exists an 'association' or 'arrangement' between tipper and tippee is difficult to justify. That requirement presumably reflects an emphasis upon a 'wrong' by the tippee in seeking to take advantage of information provided by the insider, but is questioned if the proper focus is upon the effect of the tippee being possessed of such information while trading in the market. The advantage to the tippee in having received inside information is not the less because the tip originated other than in an association or arrangement between the parties. The tippee who takes advantage in trading of the information received from an insider should not be entitled to remove himself from the scope of insider trading regulation by asserting that he had no arrangement to receive the information, although he traded once having received it.

Insider Trading and the Chinese Wall

The scope of insider trading legislation will be a matter of substantial importance for the multiple function financial or investment institution such as the financial adviser or merchant bank. Clearly, the financial adviser's or merchant bank's dealings with its corporate client will often provide it with information which could be material in making investment decisions as to the client's shares[52], whether in the strong sense of being likely to affect the price of the shares on the market or in the weaker sense of being likely to affect the trading decisions of the reasonable investor. Such conflicts may also arise for the broker which acts as underwriter to an issue, purchases shares on its clients' instructions, and advises clients as to the investment in particular shares.[53] These conflicts involve the statutory prohibition upon tipping, the duty of confidence owed to a corporate client from which information was received, and the broker's duty to his investment clients.[54] In each case, the doctrine of agency raises substantial problems where one employee of a multiple function institution or broker is possessed of inside information and another employee is engaged in investment advising in areas where such inside information is material.

The most commonly adopted solution to such conflicts is of course the chinese wall, which is intended to restrict the passing of price-sensitive information to employees or departments of a firm engaged in trading or in advising where that information arises from a confidential relationship with a corporate client. The

52 Herzel & Colling, *op. cit.* 76.
53 Lipton, M. & Mazur, R., 'The Chinese Wall Solution to the Conflict Problems of Securities Firms' (1975) 50 *New York University Law Review* 459, 460.
54 *Ibid.* 465; Note (1974) *Harvard Law Review*, 396, 396-7.

chinese wall will typically be characterised by 'policies and procedures governing dissemination of the information and on occasion through physical separation of departments'.[55] The effect of the chinese wall, its proponents would argue, is that where a department engaged in trading or advising as to securities does not have access to information obtained by another department in an advisory or underwriting capacity

> there is, first, no chance of violating any duty to the corporate source of such information by disclosing it, and second, no possibility of violating the duty to the investing public by trading or tipping on the basis of inside information.[56]

The American cases have shown a reluctance to accept the effectiveness of chinese walls as a defence against breaches of Rule 10b-5, at least where no restricted list or stop list procedure is adopted. In particular, the American courts have refused to allow that where a multiple function financial institution is under conflicting duties, it can justify failure to disclose material information to its investment clients while continuing to advise them by asserting conflicting obligations which it has brought upon itself.[57]

The Securities Industry Code reflects greater acceptance of the chinese wall. Section 128(7) recognises the chinese wall as taking trading by a company officer or by the company outside the scope of the prohibition upon insider trading, so long as the decision to trade is taken by an officer other than the officer in possession of inside information, the company has adopted arrangements to ensure that the officer responsible for the trading does not receive information or advice concerning the transaction, and 'the information was not so communicated and such advice was not given'.[58]

The encouragement of chinese wall procedures within multiple service financial institutions has justification as at least reducing the likelihood of insider trading, and the recognition of the chinese wall under section 128(7) can be supported on that ground. The practical effectiveness of the chinese wall remains a matter of some doubt, although the stronger a particular company's compliance systems the more likely it is that the chinese wall will be effective. A possibility of 'cracks' in the wall arises from executive staff common to departments of the company, and from informal dealings between staff in the separated departments.[59] This possibility is not a substantial obstacle to the recognition of the chinese wall for regulatory purposes, where the legislation places the onus upon the company to demonstrate the effectiveness of its internal procedures for restricting the flow of information.[60]

Section 128(9) looks to the situation of the broker which is in possession of inside information as to a company's securities, exempting the holder of a

55 Anisman, *op. cit.* 82; Herzel & Colling, *op. cit.* 88.

56 Note (1974) Harvard Law Review 396, 411.

57 *Black v. Shearson Hamill & Co.* 22 Cal. App. 2d 363 (1968); *Slade v. Shearson Hamill & Co.* 517 F 2d 398 (1974); Hunsicker, S. R., 'Conflicts of Interest, Economic Distortions, and the Separation of Trust and Commercial Banking Functions' (1977) 50 *Southern California Law Review* 611, 636, 638.

58 Anisman, *op. cit.* 84; Baxt, R., *et al*, *An Introduction to the Securities Industry Codes*, (1982), 259.

59 Anisman, *op. cit.* 82.

60 *Ibid.* 83; Halstead, *op. cit.* 9.

dealer's license from liability under section 128 where the dealing is in relation to listed securities, is entered by the dealer 'pursuant to a specific instruction' by a client to effect the transaction, where the dealer has not given advice to the client in relation to dealing in securities of that class, and the dealer and the client are not associated. Significantly, section 128(9) allows the exemption without requiring that a chinese wall exist so as to prevent inside information possessed by the broking firm being communicated to the broker executing the trade.

This test is substantially less demanding than that adopted in the United States, where the abstention from advising the client *and* the existence of a chinese wall appear to be the minimum requirements to avoid liability under Rule 10b-5.[61] On one view, it is sufficient to protect investor expectations that a broking firm which comes into possession of inside information, even in the absence of a chinese wall to prevent such information becoming known to individual brokers, ceases to advise its clients as to the relevant securities.[62] Where a chinese wall is in fact in place within the broking firm (although not required in order to fall under the exemption in section 128(9)), the broker's ceasing to advise its clients avoids the difficult situation arising where a broker recommends a purchase of shares on the basis of publicly available information while another division of the firm possesses inside information indicating that the recommendation is ill-advised.[63] The latter situation might arise if a chinese wall only were adopted.

It remains that determining whether information in the possession of the firm is such that it should cease to offer investment advice is difficult in practice, while the cynical might doubt that brokers have typically erred on the side of caution. Moreover, where in order to gain the benefit of section 128(9) a broking firm adopts a policy of ceasing to advise clients as to shares as to which it possesses inside information, its ceasing to advise in a particular case may have a significant signalling effect, being interpreted in the context of existing market rumours.[64] The exemption under section 128(9) raises difficulties of enforcement, since it will generally be difficult to prove that a broker in fact offered advice to a client. It should be noted that the exemption available to the holder of a dealer's license under section 128(9) would not assist the dealer which had in fact offered advice to its client, or the holder of an investment adviser's licence under section 45 of the Code.

In appropriate circumstances, an incorporated dealer or investment adviser might seek to rely upon section 128(7) as providing an exemption from liability for 'dealing' under section 128(6). This result may allow an anomalous competitive advantage to incorporated dealers and investment advisers, since section 128(7) would not establish a defence against liability under sections 128(1), 128(2) or 128(3) where the dealer or investment adviser was an unincorporated body. Anisman recommended that the chinese wall defence be extended to unincorporated financial intermediaries.[65] In the interests of competitive equal-

61 Lipton & Mazur, *op. cit.* 472-3.
62 Note (1974) *Harvard Law Review* 396, 421.
63 Lipton & Mazur, *op. cit.* 467-8.
64 *Ibid.*; Rider *op. cit.* 273.
65 Anisman, *op. cit.* 86.

ity, this recommendation ought to be adopted. If the existence of a chinese wall alone is sufficient under section 128(7) to avoid breach of the insider trading prohibition by one division of an incorporated dealer or adviser dealing in securities while another division possesses inside information, then the Australian provisions are again less restrictive than the American approach, under which a 'restricted list' or 'stop list' would be required.

A further area of difficulty involves the legal effectiveness of the chinese wall as a defence to breach of any duty owed by a multiple function financial institution to its investment client. The problem arises here if the incorporated financial institution is under a 'fiduciary' duty to its client to use all material information in its possession, including inside information, in offering investment advice.[66] If the information possessed by an employee is attributed to the company on agency principles, then on one view the possibility of breach of duty by the company remains even where it has adopted a chinese wall and avoided breach of section 128.[67] The response to this argument must be that — even if the institution's duty to its investment client were given its widest extension — there can be no breach of that duty in not revealing inside information, since such a duty cannot require the breach of the institution's obligations under the Code.[68]

If an incorporated investment adviser has advised its clients that it has adopted a chinese wall, there is a strong argument that the scope of any fiduciary duty to its clients has been restricted so as not to require disclosure of information attributed to the company because it is in the possession of one department, where the chinese wall prevents disclosure of that information to the department offering investment advice.[69] The restriction of the scope of the adviser's duty by agreement between adviser and client seems unobjectionable, at least where the client is a sophisticated investor. Whether such restriction should be allowed effect where the investor is not a professional or institutional investor is open to greater question. American commentators, perhaps not surprisingly, have emphasised the expectations of the 'average public investor who relies upon the recommendations of a broker-dealer' as contrary to giving effect to such a restriction.[70] It might be doubted whether the 'average public investor' is wholly unsophisticated, and whether he would in fact expect that investment advisers will use information possessed by other divisions of the firm in making particular recommendations.

66 Herzel & Colling, *op. cit.* 80. Query whether in Australian law the financial institution's duty to its client is fiduciary rather than typically merely contractual, and whether it extends to imposing such an obligation.

67 Eisenberg in: Panel Discussion, 'Conflicts of Interest and the Regulation of Securities' (1973) 28 *Business Lawyer* 545, 549; Anisman, *op. cit. 83*

68 Lipton & Mazur *op. cit.* 475. Note also Section 65A of the Code, which is contravened where an adviser does not have a reasonable basis for an investment recommendation. Section 65A(2)(a) requires that the adviser has, having regard to his knowledge of the client's situation, 'given such consideration to, and conducted such investigation of, the subject matter of the recommendation as is reasonable in all the circumstances'. An investigation would not, in the writer's view, be unreasonable merely because a chinese wall prevented certain information coming to the investment adviser's knowledge .

69 Herzel & Colling, *op. cit.* 89. As to the restriction of the scope of fiduciary duty in Australian law, see *Birtchnell v. Equity Trustees, Executors and Agency Limited* (1929) 42 C.L.R. 384, 408 per Dixon J., and *N.Z. Netherlands Society v. Kuys* [1973] 2 All E.R. 1222 *per* Lord Wilberforce, 1225-6.

70 Lipton & Mazur *op. cit.* 502.

As a matter of policy, it appears that the chinese wall ought to be accepted as a reasonable solution to the conflicts facing the multiple service firm, since any other result would impose substantial economic costs in requiring divestment of functions by such bodies.[71] Short of divestment, the structure which most fully reduces the risk of failure of the chinese wall to prevent the flow of information in a particular case is the separation of corporate and investment advisory functions by shifting one or the other to a discrete subsidiary. If the parent and the subsidiary — at the cost of a loss of synergistic effect — conduct separate operations, then there will be little risk of the possession of inside information from corporate clients impacting upon investment advising functions, or of conflicting duties to corporate and investment clients.[72]

The dilemma of privity and civil remedies for insider trading

Anisman's Issues Paper made its most radical recommendations in relation to the civil remedies against insider trading. It is now clear that those recommendations have little prospect of adoption, and the remedies provided in the Code in respect of insider trading are likely to retain their present form in the immediate future.

Section 130(1) of the Code provides that a person who contravenes sections 128(1), 128(2), 128(3) or 128(4) or a body corporate which contravenes section 128(6) by dealing in securities when an officer was in possession of inside information within the scope of sections 128(1) or 128(2) is liable to compensate any other party to the transaction for loss suffered by that party, and to account for any profit to the body corporate the shares of which were traded.

The loss suffered by the other party to a transaction is presumably the difference between the price paid for the shares and their market value if the relevant information had been publicly available at the time of the transaction.[73] It might be noted that, on the face of section 130(1)(d), the profit recoverable by the company is not limited to the increase in market value of the shares attributable to the insider's possession of inside information, but extends to profit deriving from an increase in the market value of the shares for other reasons. This result is justifiable to the extent that it denies the insider the benefit of his trading, but it might be questioned why the company has a better claim to any windfall profit than the other party to the transaction, who may well have chosen to retain the shares had the inside information been publicly available.

It is clear, of course, that the requirement of privity imposed by the phrase 'any other party to the transaction' in section 130(1)(c) operates as a limiting mechanism, to restrict the range of the liability of the insider in damages.[74] The restriction of liability to persons trading with the insider indirectly restricts the

[71] *Ibid.* 463, 495. For a contrary view in the context of U.S. banks having trust divisions, see Eisenberg's question 'why the law should permit institutionalized conflicts of interest, particularly where the scale is so massive and the conflicting functions so important to the economy': *op. cit.* 555.

[72] Eisenberg, *op. cit.* 555.

[73] Skoyles, *op. cit.* 23.

[74] On the application of limiting mechanisms to liability for negligence causing economic loss, see Glass, H. H., 'Duty to Avoid Economic Loss' (1977) 51 *Australian Law Journal*, 372.

liability to the number of shares traded, so that the insider's liability in damages would tend to reflect his profit on the transaction.[75] Anisman rightly recognised that, absent such a limiting mechanism, the result of imposing liability on the insider for losses experienced by all investors trading during the period in which the inside information had not been disclosed 'would likely be so out of proportion to the insider's wrong as to become inordinately punitive'.[76]

The problems of limiting the insider's liability for loss are difficult, and perhaps insoluble in a manner consistent with principle. There is in this context no accepted criterion of 'proximity' analogous to that adopted as a limiting mechanism in relation to liability for economic loss.[77] The American cases have indicated the difficulties without resolving them. Thus in *Shapiro v. Merrill Lynch*[78] the Court was prepared to impose upon the insider liability to all investors buying and selling the securities in which the insider traded prior to disclosure of the information. On this approach, the insider's liability will often exceed, possibly by a large margin, his profit on the transaction. In *Fridrich v. Bradford*[79] the Court recognised the extremity of the result in *Shapiro*, and held that the insider was not liable to an investor whose transaction was well separated in time from the insider's trading, although prior to public disclosure of the inside information. In *Elkind v. Myers Inc.*,[80] in relation to the liability of a tipper, the Court restricted the tipper's liability to the amount of profit made by the tippee, its reasoning suggesting that a similar restriction would apply to liability of the insider who himself traded. Such a result is attractive in practice, and supportable as a form of accounting of profits, but hardly consistent with the basis of common law damages as being to compensate the injured party for his loss.

Anisman also noted — the point is significant, if hardly novel — that section 130(1)(c) as presently framed leads to fortuitous results when applied to transactions on the stock exchange, since the matching of buy and sell orders will typically have been random, and 'there is no relevant difference between [the other party to the transaction] and other investors trading during the same period'.[81] There can be little doubt that this observation is accurate. To allow recovery to one or a small number of investors who by chance trade with the insider in a public market has no justification in principle. It is equally clear that the approaches adopted by the American courts either raise the prospect of indeterminate liability of the insider, or impose limitations upon that liability which are sound in practice but questionable in principle. Anisman's proposals,

75 Anisman, *op. cit.* 112.
76 *Ibid.* 103.
77 *San Sebastian Pty Limited v. Minister Administering the Environmental Planning and Assessment Act* (1987) 61 A.L.J.R. 41; (1986-87) 162 C.L.R. 340. The majority (Gibbs C.J., Mason, Wilson, Dawson JJ.) 44-45 note that '[t]he recovery of economic loss has traditionally excited an apprehension that it will give rise to indeterminite liability', and recognise the function of the proximity test as 'limit[ing] the loss that would otherwise be recoverable if foreseeability were used as an exclusive criterion of the duty of care.'
78 495 F. 2d 228 (1974).
79 542 F. 2d 307 (1976).
80 635 F. 2d 156 (1980).
81 Anisman, *op. cit.* 111.

which required establishing a statutory fund for compensation of investors, and provided for a statutory liability of three times the insider's profit in the transaction and for *pro rata* distribution among injured investors, were both complex in structure and inconsistent with common law principles of damages.

Any alternative approach must either limit the class of investors trading in a public market to whom the insider is liable, or place a statutory ceiling upon his liability, or both. If a statutory limit is placed upon the insider's liability, then the class of investors suffering loss as a result of the insider's conduct must be defined in order to allow any damages to be apportioned between them. In the absence of recognition of class actions in Australian courts, such apportionment raises the administrative difficulties which have been urged against Anisman's proposals. The concept of 'proximity' as a means of limiting the insider's liability, by analogy with the principles defining the duty of care in relation to negligence causing economic loss, may be no more satisfactory in this context. If such a notion were given statutory application to civil liability for insider trading, it would raise problems of lack of certainty, and would again leave the insider exposed to the possibility of liability substantially exceeding his profit. It may be that the demands of policy here are such that the concept of damages is deficient as a means of defining the insider's civil liability.

Insider trading and extraterritoriality

The issue of the extraterritorial application of section 128 involves real uncertainty. The issue is likely to have substantial practical importance, given recent American examples of insider trading occurring outside the jurisdiction,[82] and given the use in Australia of overseas vehicles in other contexts, on occasion arguably for the purpose of avoiding the application of the Code.[83]

The conduct and effect test adopted in American courts generally applies Rule 10b-5 to insider trading in securities of American companies occurring outside the jurisdiction, the issue being whether such trading has a substantial, direct and foreseeable effect within the United States although no conduct takes place within the jurisdiction. Thus in *Schoenbaum v. Firstbrook*,[84] the Court justified extraterritorial application of the Securities Exchange Act 1934 on the basis of a legislative intention to 'protect domestic investors who have purchased foreign securities on American exchanges and to protect the domestic securities market from the effects of improper foreign transactions in American securities'. The Court held on the facts that sale of a Canadian company's shares in Canada at an

[82] U.S. examples include insider trading occurring before the merger of Santa Fe International Corporation and Kuwait Petroleum Company, discussed by Anisman, *op. cit.* 129.

[83] In the substantial shareholder context, see *C.A.C. v. Orlit Holdings* (1983) 1 A.C.L.C. 1038; and in the takeover setting see *Adsteam Building Industries Pty Limited v. Queensland Cement & Lime Co Limited* (1984) 2 A.C.L.C. 829; *Humes Limited v. Unity APA Limited* (1987) 11 A.C.L.R. 641.

[84] 405 F. 2d 200 (1968) at 206. See also *Bersch v. Drexel Firestone Inc.* 519 F. 2d 974 (1974). For American criticism of the conduct and effect test as failing to address the appropriate policy issues in asserting extraterritorial application of American law, and advocacy of a 'balancing' approach to the competing factors, see Thomas, B., 'Extraterritoriality in an era of Internationalization of the Securities Markets: The Need to Revisit Domestic Policies' (1983) 35 *Rutgers Law Review* 453, 459.

unfairly low price was within the scope of Rule 10b-5 where such a sale depressed the value of shares in the company listed on U.S. Exchanges. There is no Australian authority adopting so wide a test, and its future adoption in Australia must be regarded as highly unlikely.

The basis of the extraterritorial effect of Australian securities legislation would be an express or inferred parliamentary intention to legislate on an extraterritorial basis.[85] Where the Code takes effect under the Commonwealth's legislative power, as in the Australian Capital Territory, then it is clear that the Commonwealth Parliament has power to legislate with extraterritorial effect.[86] Prior to the passing of the Australia Act 1986 (Cth and U.K.), it appeared that the Australian states also had the power to legislate with extraterritorial effect provided that there existed a sufficient connection between the state and the subject matter of the legislation.[87] The decision in *Myer Emporium Limited v. Commissioner of Stamp Duties*[88] indicated that, at least in the context of stamp duty legislation, the incorporation of a company in a state would be a sufficient nexus to give legislation relating to the transfer of shares extraterritorial effect.

In the writer's view, even prior to the passing of the Australia Acts 1986, the fact that shares were issued in a company incorporated in an Australian state, whether traded on an Australian or an overseas exchange, would have been sufficient connection with the state to establish a power in the state Parliament to legislate extraterritorially to prohibit insider trading and impose penalties to support that prohibition. In any case, it appears that the Australia Acts establish a general grant of extraterritorial legislative power to the states, and remove any separate requirement that the legislation have a nexus with the enacting state.[89]

The fact that the states may have had power to legislate extraterritorially as to insider trading does not establish that section 128 indicates an intention to do so. There is Australian authority that a state legislature may make an offence committed outside the jurisdiction punishable, provided that 'there is in the prohibited act an element sufficiently connected with the state'.[90] There is however a presumption against criminal liability for acts which occur outside the jurisdiction.[91] Section 129 creates an offence punishable by fine or imprisonment for breach of section 128, and in the writer's view the policies underlying section 128 are such as to rebut the presumption against extraterritorial criminal liability.

Neither the Code as a whole nor section 128 in particular expressly indicate an

[85] N.C.S.C. Release 406, 'The extra-territorial aspects of Australia's Securities Laws', 5 March 1985: text of a paper given by L. Masel. See also Masel, L., 'Extra-territorial application of securities laws: an Australian viewpoint' *Current Developments in the extra-territorial application of laws: Australia, Canada and the United States*, International Law Institute, 1983.

[86] *Robinson v. The Western Australian Museum* (1977) 138 C.L.R. 283 *per* Barwick C. J., 294.

[87] *Pearce v. Florenca* (1976) 135 C.L.R. 507 *per* Gibbs J. 517, observing that state legislation is valid 'if it is connected, not too remotely, with the State which enacted it, or, in other words if it operates on some circumstance which really appertains to the State.'

[88] [1967] 2 N.S.W.L.R. 230.

[89] Moshinsky, M., 'State Extraterritorial Legislation and the Australia Acts 1986' (1987) 61 *Australian Law Journal* 779.

[90] *Ex parte Iskra* [1963] 63 S.R. (N.S.W.) 538 *per* Brereton J., 552. See also Kelly, D., *Localising Rules in the Conflict of Laws*, (1974), 89-90.

[91] *CEB Draper & Sons Limited v. Edward Turner & Sons Limited* [1965] 1 Q.B. 424 *per* Lord Diplock, 435.

extraterritorial intention[92], although it should be noted that the prohibition in section 128(6) is directed to a 'body corporate' rather than to a 'company', the latter being restricted by the definition in section 5(1) of the Companies Code to a company incorporated or deemed incorporated under the Code or previous state Companies Acts. The extraterritorial effect of the legislation therefore depends upon choice of law criteria looking to statutory interpretation and to the policy and purpose of the legislation.

Commentators have identified two approaches to reading the scope of operation of a forum statute which have support in the authorities[93]. On the first approach, the forum statute is confined to those transactions governed by the law of the forum under the forum's choice of law rules. The judgment of Dixon J. in the *Wanganui* case[94] is the primary authority for this approach, although his Honour there recognised that this approach was a rule of construction only, and that the subject matter of the legislation might supply a different restriction.

On the second approach, the court develops choice of law criteria based upon statutory interpretation and upon policy considerations, including identification of the mischief to be remedied by the statute. This approach has been adopted in the interpretation of forum statutes having apparently general application.[95] In the writer's view, this approach is likely to be adopted by Australian courts in relation to the Securities Industry Code in the absence of an express statement of parliamentary intention.

If Australian courts were therefore to look to the policy of the legislation in interpreting particular sections of the Code, and if the Code is seen as having merely the purpose of regulating the Australian securities markets, then it might be argued that such a purpose does not require that the application of section 128 be extended to trading in Australian shares on overseas exchanges. Quite apart from the possibility that insider trading in shares in Australian companies on overseas markets might in fact impact on trading behaviour on the Australian Stock Exchange, it is arguable that this view of the purpose of the Code is too narrow.

If the purpose of the Code is seen as being to protect Australian investors, then the Code should be allowed extraterritorial effect in relation to insider trading to which an Australian investor is party. The widest view is that the purpose of the Code extends to maintaining the integrity of the market in shares in companies incorporated in Australia, although trading in those shares takes place offshore. On this view, even if no Australian investor is involved, section 128 should be allowed extraterritorial effect since insider trading overseas denies equality of

[92] N.C.S.C. Release 406, *op. cit.*; Bennett, H. T., 'Extraterritorial Issues: An Australian Perspective' *Asian Pacific Regional Law Seminar*, (1984), 19-21. Bennett notes that section 123(1) of the Code indicates an express intention to legislate extraterritorially, as do section 10 of the Companies (Acquisition of Shares) Code and section 135 of the Companies Code.

[93] Sykes, E. L., & Pryles, M. D. *Australian Private International Law*, (1979), 122-6. A third approach is that of Evatt J. in *Barcelo v. Electrolytic Zinc Co. of Australasia Limited* (1932) 48 C.L.R. 391, 433–4, with effect that where the statute is within constitutional power, then it will regulate the rights of the parties as though the transaction had occurred within the jurisdiction. Sykes & Pryles, *op. cit.* doubt that this approach is consistent with the authorities.

[94] (1934) 50 C.L.R. 581 *per* Dixon J. 601.

[95] *Ibid. per.* Gavan Duffy C. J., Starke J. 597; *Kay's Leasing Corporation Pty Limited v. Fletcher* (1964) 116 C.L.R. 124 *per* Kitto J. 144; Kelly, *op. cit.* 7ff; Sykes & Pryles, *op. cit.* 125.

access to information as to shares in Australian companies and may reduce investor confidence in Australian markets, both effects being contrary to the policies underlying the Code.[96] This view is scarcely distinguishable from that adopted by U.S. courts. The widest view risks the clashes of jurisdiction which have characterised U.S. assertions of extraterritorial jurisdiction in the antitrust context. Where no Australian investor is involved, Australian courts would probably hold that an offshore transaction should be regulated by the securities law of the jurisdiction in which it occurs.

Conclusion

We have reviewed the continuing argument among commentators as to the economic justifications for prohibiting insider trading. It was suggested that justifications for prohibiting insider trading may be developed on fiduciary principles, or by reference to legally unerodable inequalities of information. Such justifications have some common ground, perhaps reflecting a deeper sense of the need for a minimum standard of 'fairness' in the market, but their application may lead to different results as to the appropriate scope of insider trading regulation, and to contrary identifications of the persons suffering loss where an insider has traded in breach of duty.

We considered the definition of the 'insider' category under section 128 of the Code. An approach based upon informational factors rather than upon the 'fiduciary' status of the insider provides the most coherent justification for extending insider trading prohibitions to impersonal markets, and to persons who are outside the scope of traditional fiduciary categories such as substantial shareholders and takeover bidders. In this context, the decision in *Hooker Investments Pty Limited v. Baring Bros Halkerston* leads to sensible results in applying the prohibitions under sections 128(1) and 128(2) to natural persons connected with the company under section 128(8), and in holding section 128(b) to be the source of the prohibition upon dealing by corporate bodies.

The approach to the 'materiality' of inside information under section 128 was contrasted with the approach proposed in Anisman's Issues Paper. On either approach, the Court is likely to consider common factors, since information which a reasonable investor would consider relevant to trading decisions is likely to be information as to the price of the securities. The effect of a shift from price effect to a standard of relevance to the investment decision of a reasonable investor would nonetheless be significant, since it would locate the issue of 'materiality' as a question for the court rather than as requiring expert evidence.

The liability of tippees has been the subject of alternative approaches, whether treating the tippee's breach as deriving from that of the insider, assimilating the position of the tippee with that of the insider, or placing the tippee under a separate statutory category as in section 128(3) of the Code. It was noted that section 128(3) is unduly limited, in requiring an 'association' or 'arrangement' between tipper and tippee in order to establish liability of the tippee.

[96] By contrast, Masel concluded that it was 'unlikely that Australian courts would support attempts to give effect to the securities industry legislation extra-territorially': N.C.S.C. Release 406, *op. cit.*

Section 128 recognises the chinese wall as a defence to dealing by a corporation where an officer of that corporation possesses inside information, and allows specific protection under section 128(9) for a broker trading on his client's specific instructions and without having advised the client in relation to dealing in securities of the class traded. It was noted that section 128(9) does not require that the broking firm have a chinese wall in place. Section 128(7) allows an exemption from liability under section 128(6) where a company has a chinese wall in place, but provides no comfort for unincorporated bodies. It was suggested that the broker or investment adviser is not in breach of his duty to his client in complying with the prohibition upon trading on or tipping using inside information imposed by section 128, and that his advising his clients of the existence of a chinese wall within his firm operates as a restriction on the scope of his fiduciary duty to his client.

Three issues in insider trading regulation raise particular difficulty. The civil remedies under section 130 are not well directed to insider trading on a public market, while the problems raised by such trading have no clearly acceptable solution. The requirements of principle and of policy are here difficult to reconcile, given the possibility of liability of the insider for losses far exceeding his profit on the transaction if the scope of recovery by persons trading in the market is not restricted. The issue of the extraterritorial application of section 128 remains open in the absence of Australian authority on the point.

The issue of greatest difficulty, however, is one of practice and not of law. The extent of insider trading in the Australian market is unknown, although there is some force in Halstead's observation that, given the comparative thinness of the Australian securities market, insider trading may be less common than price fixing and 'ramping'.[97] Hogan rightly observes that Anisman's Report does not address the inadequacies of enforcement of present insider trading legislation.[98] It may be difficult or impossible for regulatory authorities to detect insider trading in public markets, in the absence of a substantial commitment of resources to computerised monitoring of trading patterns by either the Australian Stock Exchange or the National Companies and Securities Commission.[99] The successful application of the insider trading legislation may ultimately be a matter not of law reform, but of a regulatory commitment to surveillance of the securities markets and a willingness to undertake enforcement proceedings.[1] Such commitment may not be achievable if the regulatory authorities lack the resources to undertake prosecutions which in a commercial setting are likely to be strongly defended.

97 Halstead, *op. cit.* 9–10.
98 Hogan, *op. cit.* 42.
99 English, *op. cit.* 8; Samuel, *op. cit.* 71.
1 English, *ibid.*