

# AN OUTSIDER'S PERSPECTIVE OF INSIDER TRADING REGULATION IN AUSTRALIA

*JAMES D. COX\**

Insider trading<sup>2</sup> of one form or another has most certainly been a part of society as long as markets have existed. As one peruses the world press it is clear that appetite for prosecuting insider trading is world-wide. In the Pacific Basin, New Zealand and Japan have each just embraced their first national proscriptions of insider trading. Australia is currently caught in a debate about how its untested insider trading provisions can be further strengthened. The anomaly throughout these developments is the lack of agreement among the bar, members of Parliament, courts and even regulators over who or what is harmed by insider trading. Indeed, even a few experienced securities lawyers opine that insider trading is a victimless offence.

The following provides a close analysis of contemporary justifications frequently advanced for the regulation of insider trading. So as not to leave the reader with only a criticism, the author provides a coherent rationalization for the prosecution of insider trading. This rationalization is then contrasted with the objectives and provisions of Australia's recently enacted Corporations Act of 1989. The final section of the paper provides reaction to the many complaints others have raised regarding weaknesses inherent in the former regulatory framework that placed the National Companies and Securities Commission at the center of Australia's regulation of insider trading. This latter analysis provides a basis for

---

\* Professor of Law, Duke University, Senior Fulbright Fellow, Faculty of Law, University of Sydney.

<sup>1</sup> The author is very much in the debt of Professor Robert P. Austin for his support and invaluable assistance in this project and the resulting article. The author, of course, is solely responsible for any deficiencies readers may find in the article.

<sup>2</sup> For the purpose of brevity, the expression "insider trading" when used in this article includes also wrongful tipping as well as trading on such a tip. All such practices are strictly proscribed under the laws of both America and Australia.

optimism that the newly created Australian Securities Commission will not suffer the same institutional difficulties that this article believes seriously eroded its predecessor's effectiveness.

## I. IS INSIDER TRADING A VICTIMLESS CRIME?

### A. *The Unfairness Argument:*

The most elusive complaint lodged against insider trading is that it is "unfair". This complaint has two distinct aspects. First, the insider is seen as having an unerodible advantage over others who cannot obtain the same information. Second, the information was produced not for the benefit of the inside trader, but rather as a result of his employer's quest for gain.<sup>3</sup> As will be seen, the second point is an indispensable qualification of the first in characterizing insider trading as unfair, because the experience, intelligence, resources, or position of some investors will always give them superior insight into prospective market developments. No one believes it is unfair for an investor to purchase a security without disclosing his belief that the stock is a "bargain". On the other hand, disclosure of such information would be dysfunctional because it would deprive market professionals of the incentive necessary for them to continue their arbitrage of stock prices in light of publicly available information.<sup>4</sup> Similarly, the gains employers derive from this socially desirable behavior is eroded, and hence such incentive behavior stifled, if employees can make a preemptive use of such information.<sup>5</sup> An illustration closer to the shores of Australia is the ability of a bidder to secretly acquire a substantial amount of a target corporation's stock without first disclosing its intent to make an above market bid.<sup>6</sup> In short, the concept of "unfairness" represents nothing more than a highly stylized line separating lawful and unlawful conduct. The concern here is not simply to protect the benefits garnered by the production of information, but also the economic gains arising from that information's use by its producer.<sup>7</sup> Thus, most assertions that insider trading is unfair are coupled with additional harms believed to accompany insider trading.<sup>8</sup>

---

<sup>3</sup> See Brudney, "Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws", 93 *Harv. L. Rev.* 322, 356-57 (1979).

<sup>4</sup> See Hethrington, "Insider Trading and the Logic of the Law", (1967) *Wis. L. Rev.* 720, 725-30.

<sup>5</sup> See Barry, "The Economics of Outside Information and Rule 10b-5", 129, *U.Pa. L. Rev.* 1307, 1323-28 (1981).

<sup>6</sup> Consider that the bidder need not even identify that it is a substantial holder of another company's stock until it has acquired 5% of that class of stock and thereafter it need not reveal in connection with its purchases its future intentions until a bid is even commenced.

<sup>7</sup> See Fleischer, Mundheim & Murphy, "An Initial Inquiry into the Responsibility to Disclose Market Information", 121 *U.Pa. L. Rev.* 798, 808-09 (1973).

<sup>8</sup> For example, Professor Brudney coupled his argument of unfairness with concerns for market efficiency, market integrity, manipulative practices, and the cost of capital. Brudney, *supra* at 334-35, 356.

### **B. Harm to Investors:**

It is frequently asserted that insider trading harms investors. It is very difficult in most cases to identify who is injured by the trading in, or tipping of, material nonpublic information. To wit, an investor's decision to sell or to purchase is unaffected by whether the insider is also secretly buying or selling in the open market. If the insider neither trades nor discloses his confidential material information, one can nevertheless expect the investor to pursue his trading plan. To be sure, sellers are naturally disadvantaged by the nondisclosure of good news, just as buyers are disadvantaged by the nondisclosure of bad news. These results, however, cast no light on why the insider's decision to trade should prompt disclosure. Nor does it identify why or how the insider's trading, disassociated from his failure to disclose, harms his opposite trader. Viewed in such a limited fashion, the insider's trading is a mere fortuity as to his contemporaneous opposite traders.<sup>9</sup>

Modest support for the disclose or abstain rule can be found if the trading and nondisclosure aspects of insider trading are disaggregated. Certainly the insider's trading does impact the supply and demand for the security traded in, so that the insider may preempt a price that was a lower "buy" price or a higher "sale" price than what would have been available to the investor if the insider had abstained from trading.<sup>10</sup> Under such a rationalization, the investor's injury is both problematic and trivial. It is purely in the realm of speculation what price would have been available to outside investors but for the insider's trading. Moreover, in a goodly number of cases, the resolution of this sticky factual question would appear hardly worthy of the considerable effort its resolution would entail. It would appear that in the vast majority of the cases, the insider's trading will have minimal impact on a stock's price. Moreover, there should also be considered the potential benefits such insider trading may have conferred on parallel traders, those who also purchased when the insider purchased; for this group, the price and volume changes stimulated by the insider's trading may have attracted others to similarly trade so that such parallel traders unwittingly invested "in a sure thing". But the ultimate problem with the argument that the misdeed of insider trading is that the insider preempts a price otherwise available to others is that this assertion begs the question. Insiders are permitted to trade and thereby preempt a price available to outsiders when they are not in possession of inside information; therefore, why should they not similarly be free

---

<sup>9</sup> The fortuity is clear from analysis of the casual attitude American courts demonstrate when imposing arbitrary guidelines defining the class of investors permitted to share in the recovery of insider trading profits. See e.g., *Elkind v. Liggett & Myers, Inc.*, 635 F.2d 156, 172 (2d Cir. 1980) and *Fridrich v. Bradford*, 542 F.2d 307, 321 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

<sup>10</sup> Wang, "Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?", 54 *S. Cal. L. Rev.* 1217, 1235-40 (1981).

to trade and preempt a price when they are in possession of inside information?

**C. Manipulation Accompanies Insider Trading:**

Insider trading regulation has frequently been justified on the basis that its proscription is necessary to protect securities markets from manipulative practices that would otherwise accompany a policy of *laissez faire* toward insider trading.<sup>11</sup> Tardy corporate disclosures would be the most likely form of manipulation. Delay gives insiders and others time needed to capture a greater share of the changes in the firm's value. Ambiguous corporate disclosures and signals can also be employed to create market uncertainty against which insiders can further their secret trading agenda. And insiders may even alter the timing of corporate activities for the sole purpose of creating intertemporal swings in the firm's value. In all cases, insiders can thereby reap the gains from their privileged knowledge of the direction of stock price movements.

Those who believe such abusive practices are far fetched should consider the on-going private action by FMC corporation against Mr Ivan Boesky.<sup>12</sup> FMC's investment banker secretly advised FMC to increase by \$10 the consideration to be offered in its restructuring. On the basis of their secret knowledge of this dispute, Messrs Boesky and Levine allegedly undertook massive purchases of FMC stock for the purpose of causing FMC's management to approve the higher price. So massive were their purchases that they accounted for more than 50% of the trading volume during a one month period. The trading drove FMC stock to a level that did in fact cause FMC to increase the cash amount to be offered, thereby raising the total consideration by \$220 million, producing a \$20 million gain to Boesky.

To be sure, it is a rare inside trading case where such abusive practices have accompanied the insider's trading agenda. This does not imply, however, that such abuses do not more frequently accompany insider trading. Great uncertainty exists whether sound managerial judgment guided the timing of a corporate announcement and its ambiguities, the initiation or delay of a transaction, or the selection of a riskier project. Moreover, when such abuses are found, it appears far better to justify prosecution for the manipulation that occurred, rather than solely the incentive that drove that manipulative conduct. To justify insider trading regulation because of the difficulty in proving the presence of manipulative

---

<sup>11</sup> Over fifty years ago, the United State's Congress proscribed so-called short-swing profits under section 16(b) of the Securities Exchange Act of 1934 out of a concern that if disincentives to insider trading were not provided by the removal of profits that certain corporate insiders obtained by purchasing and selling their firm's securities within a six month period that the quest for insider trading profits would lead to abusive and manipulative collateral practices by such insiders. U.S. S. Rep. No. 792, 73d Cong. 2d Sess. 9.

<sup>12</sup> *FMC Corp. v. Boesky*, [1987 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 93,233 (N.D. Ill. 1987).

conduct accompanying insider trading is to perceive insider trading regulation as a necessary prophylaxis. For such a justification, a richer record of such abuse would appear to be required than currently exists.

Finally, close observers of insider trading prosecutions in America will report that most cases are against individuals who technically are not insiders. Most actions are against individuals who have no control over such intracorporate decisions, as the timing or content of corporate disclosures, let alone any control over corporate operations. In this respect, the manipulations engaged in by such glamour defendants as Messrs Boesky and Levine are rare.

#### ***D. The Allocational Efficiency Argument:***

The broadest justification some have advanced for insider trading regulation is the belief such regulation enhances investor confidence in securities markets and thereby promotes the allocational efficiency of securities markets.<sup>13</sup> While there is a good deal of public concern about insider trading, evidence that markets are adversely impacted by fears of insider trading, as distinct from other prevalent market practices, is not available. Instead of leaving the question whether the magnitude of the malaise over insider trading is sufficient to implicate the allocational efficiency of markets to one's prejudices, the case for regulation can be disposed of by assuming that investor concerns over insider trading are material. Even in light of this assumption, there is reason to doubt that the legalization of insider trading will interdict the allocational efficiency of securities markets.

Capital market theory offers a useful tool by which to examine this question. Insider trading occurs randomly because inside traders generally are not repeat players in the same corporation's stock on the basis of a separate corporate event. All firms do not experience the kinds of financial developments that offer extraordinary returns to insiders who trade before disclosure occurs. Moreover, opinion and practice will vary across managers over the propriety of their trading on insider information, regardless of the prevailing legal climate. In combination, insider trading can be viewed as a random occurrence with respect to the individual firm. Outside investors, however, do not know *ex ante* which firms' managers possess inside information or, for that matter, which firms' managers will trade and/or engage in manipulative practices when in possession of such information. Due to these informational asymmetries,

---

<sup>13</sup> That secondary securities markets affect the allocation of resources among competing productive uses is now well established. See Fama and Laffer, "Information and Capital Markets", 44 *J. Bus.* 289 (1971) and Hirschleifer, "The Private and Social Value of Information and the Reward to Incentive Activity", 61 *Am.Econ.Rev.* 561 (1971). This connection has thus stimulated most commentators to justify insider trading regulation in the belief it promotes, or at least protects, allocation efficiency. See e.g., Schotland, "Unsafe at any Price: A reply to Manne", *Insider Trading and the Stock Market*, 53 *Va. L. Rev.* 1425, 1448-49 (1967); Mendelson, "The Economics of Insider Trading Reconsidered", 117 *U.Pa. L. Rev.* 470, 477-78 (1969).

the rational investor will assume *ex ante* that each firm poses the same risk of abusive insider trading practices as does the market as a whole and will accordingly discount the value of each firm by the average estimated agency cost of all firms. In this way, the abuses associated with insider trading, while occurring randomly with any specific firm, become systematic across all firms due to the informational asymmetries that exist *ex ante*.<sup>14</sup> Because the risk is systemic, the risk cannot be reduced by diversification. Adding more stocks to one's portfolio only assures that the investor's exposure approaches that of the market as a whole.

So viewed, it can be seen that insider trading does not harm the individual investor. Each rational investor can self-insure against abusive insider trading practices by discounting all stocks by the average risk for all firms. Investors armed with an efficient portfolio will have insider trading losses on one investment offset by higher returns garnered from portfolio stocks of firms not accompanied by insider trading. Over time, an investor can expect that his portfolio's insider trading losses will sum to zero.

As seen from the above analysis, rational investors, whose collective judgments drive stock prices to their equilibrium levels, will discount all stocks *ex ante* by the perceived agency cost of the market as a whole. So viewed, it is difficult to understand how insider trading interdicts the market's allocational efficiency. Because capital allocation occurs within the context of a comparative assessment among competing choices, any change that affects the cost of capital for all firms at the same rate will not affect the relative comparisons made by investors; the comparisons which drive the allocational efficiency of markets. Therefore, investors will not discriminate between firms that produce computers and those that manufacture automobiles solely on the basis of either set's potential insider trading abuses.<sup>15</sup> Investors will view each set of firms and each firm within a set as posing the same risk of insider trading abuses. Hence, legalization of insider trading under this "lock-step" paradigm would not adversely affect the allocational efficiency on an interfirm basis. The analysis is not affected by consideration of investment opportunities that occur in markets other than securities markets. That is, it may be argued

---

<sup>14</sup> See generally, Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", 84 *Q.J.Econ.* 488 (1970).

<sup>15</sup> To be sure, it may arise that individual firms may seek to reduce their cost of capital by engaging in nontrivial bonding, monitoring and signaling costs designed both to deter insiders from harmful insider trading practices and to signal effectively that their firm poses a lower risk of such practices. Ross, "Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory", in *Issues in Financial Regulation* 117 (F. Edwards ed. 1979). See also, Dooley, "Enforcement of Insider Trading Restrictions", 66 *Va. L.Rev.* 1, 45-47 (1980). However, any such undertaking by the individual firm will balance the marginal cost of each additional unit of bonding, monitoring and signaling against the accompanying marginal benefits of reducing its managers' trading. Jensen & Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", 3 *J.Fin. Econ.* 305, 328-29 (1976). Therefore, no firm will ever be completely free from investor discounting because some level of abusive insider trading practices will remain optimal because it is not economical to stop such practices at all costs.

that investors fearing insider trading abuses in equity securities may choose to invest in bonds or even real estate partnerships. If insider trading were isolated only to equity securities markets, then allocational efficiency would be affected by its presence in such investments but not other types of investment vehicles, such as bonds or interests in partnerships. But it can hardly be expected that investors considering equity securities versus alternative investment mediums will consider any investment that requires their active participation in management. They will instead be seeking passive investment devices. All such passive investment entails either a direct managerial component or an external component that is connected with a managerial component (for example, the promoter of a parcel of land for development or investment) that embodies a relationship fraught with informational asymmetries between the investor and those within the managerial component. This situation assures that insider trading type abuses will not be limited to equity markets. Indeed, there have even been insider trading cases in risk-free treasury bills; insiders have secretly traded in treasury bills on private knowledge concerning changes in the terms of new government offerings.<sup>16</sup>

#### ***E. Protection of Another's Information:***

The most evident impact of insider trading is upon the property rights of the person for whose benefit or enterprise the information upon which the insider trades was created. The most fully reasoned opinion focusing on this dimension of insider trading's harm is that of the United States Supreme Court in *Carpenter v. United States*.<sup>17</sup> In *Carpenter*, Winans' and his accomplices' convictions for mail fraud were upheld upon proof that they had misappropriated their advance knowledge of the content of the Wall Street Journal's "Heard on the Street" column, which Winans coauthored for its publisher, Dow Jones and Company.

The Court emphasized the publisher's interest in the confidentiality of the contents and timing of the column's contents, recognizing this information as a protectable property right. "Confidential 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 the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy."<sup>18</sup> The court said the injury occurs by the misappropriation of this information, without proof of competitive injury to the publisher. It was "sufficient that the Journal has been deprived of its right to the exclusive use of the information."<sup>19</sup>

---

<sup>16</sup> See e.g., *In re Blyth & Co.*, 43 S.E.C. 1037 (1969).

<sup>17</sup> [1987 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) 93,423 (U.S. Sup. Ct. 1987).

<sup>18</sup> *Id.* at 97, 197-4.

<sup>19</sup> *Id.* at 97, 197-4-5.

Upon finding that the employer had been deprived of its property by a fraudulent scheme, the Court upheld the conviction for mail fraud.

If instances of tangible harm from misappropriating another's information is needed to convince the skeptical of the wisdom of a general proscription of insider trading, it can be found in cases such as the FMC Corporation, discussed earlier, in which Boesky's unauthorized use of confidential knowledge caused FMC to incur \$220 million in additional payments incident to its restructuring. Also consider the case involving Paul Thayer, who while a director of Anheuser-Busch Corporation, revealed its plan to make a tender offer for Cambell-Taggart Inc.<sup>20</sup> As a consequence of Thayer's tip, a significant increase occurred in the market price of Cambell-Taggart stock before Anheuser-Busch announced its offer. To assure that its tender offer price would be attractive, Anheuser-Busch raised its offering price. It was thereby forced, because of illegal tipping and insider trading, to pay about \$80 million more than first estimated for Cambell-Taggart.

To be sure, not all instances of insider trading will pose tangible harms such as those illustrated in the case of FMC and Anheuser-Busch. But the purpose of regulation should not be to proscribe that for which only tangible harm is possible.<sup>21</sup> Much like the crime of attempt, there are societal benefits for protecting the property interest from the threat of injury, whether or not injury results. In the case of inside information, the interest protected is the incentive behavior that underpins the information's production. Regulation should thus function prophylactically.

If insider trading were proscribed only when there is a distinct tangible harm to the owner of the information, curious incentives would thereby be created to trade in the hopes that no accompanying harm can be identified; such incentives are not offset by any socially useful behavior on the insider's part for having so stimulated his misappropriation and trading on the information. Moreover, the enterprise for whose special benefit the information was created will incur higher transaction costs to assure the information's confidentiality. The latter will occur because any additional element to making out the offence, in this case proof of harm, necessarily interjects an uncertainty into whether the insider will

---

<sup>20</sup> *Anheuser-Busch Companies, Inc. v. Thayer, et. al.*, CA3-85-0794-R (N.D. Texas 1986).

<sup>21</sup> American case law upholds the right of a corporation to proceed against its employees who breach their fiduciary duties by trading in securities on the basis of their employer's confidential information. However, the cases do not agree whether the employer's recovery can only occur if it suffers a tangible loss as a result of the employee's breach. Compare *Diamond v. Oreamuno*, 24 N.Y. 2d 494, 248 N.E. 2d 910, 301 N.Y.S. 2d 78 (1969) (a reputational injury can be presumed) with *Schein v. Chasen*, 313 So. 2d 739 (Fla. 1975) (recovery only upon proof of injury). Consider that *Consul Developments Pty. Ltd. v. D.P.C. Estates Pty. Ltd.*, 132 C.L.R. 373 (1975), reflects a willingness to impose a constructive trust on a tippee's profits, provided the tippee either knew or was reckless in failing to discover that the profits were the fruits of an employee's breach. Thus, *Consul* would appear not to require proof of tangible harm to the employer as a consequence of the employee's breach. See also, *Regal (Hastings) Ltd. v. Gulliver*, 2 A.C. 134 (1967).



be admonished for his offence. As between the insider and the enterprise, the latter can be expected to be the more risk averse; indeed there is reason to believe the former is risk preferring.<sup>22</sup> Hence, the effect of making a successful prosecution more difficult is that it will actually increase the incidence of violations. In sum, actual proof of harm would be dysfunctional.

## II. SEARCHING FOR THE OBJECTIVE OF REGULATION IN AUSTRALIA

Section 1002 of the Corporations Act of 1989 carries forward former section 128 of the Australia Securities Industry Act and is a highly complex proscription of insider trading. While the detail with which it carries out its task of prescribing when and by whom insider trading occurs could be indicative of a coherent focus for such regulation, close analysis belies such a favorable commentary on section 1002. Indeed, the inner core of section 1002 is vacuous.

Section 1002 proscribes a person's dealing in securities of a corporate body with which he has been connected in the preceding six months if through that connection he has possession of price sensitive information that generally is not publicly available.<sup>23</sup> The section extends its prohibitions to information about a second company acquired through a connection with another company.<sup>24</sup> Even though the requisite connection with a corporate body does not exist, trading is prohibited if it was acquired from someone having the requisite connection and he is associated, or had an arrangement with, that person for the communication of information of a kind proscribed with a view toward dealing in securities by himself or with that other person.<sup>25</sup> Moreover, the person having such connection is prohibited from trading in listed securities when the tipper knows or ought reasonably to know that the tippee will use the information for the purpose of trading, regardless of whether there exists an antecedent association or arrangement.<sup>26</sup>

The weaknesses within section 1002 become apparent when examined against the background of the American experience in regulating insider trading. America first sought the utopian quest of assuring through the prohibition of insider trading that all market participants enjoyed the same access to material information. Thus, in the landmark decision of *SEC v. Texas Gulf Sulphur Co.*<sup>27</sup> the distinguished Court of Appeals for

---

<sup>22</sup> See generally, Becker, "Crime and Punishment: An Economic Approach", 76 *J.Pol.Econ.* 169 (1968).

<sup>23</sup> Section 1002(1) of the Corporations Act.

<sup>24</sup> Section 1002(2) of the Corporations Act.

<sup>25</sup> Section 1002(3) of the Corporations Act.

<sup>26</sup> Section 1002(5) of the Corporations Act.

<sup>27</sup> 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

the Second Circuit held that *anyone* in possession of material nonpublic information must abstain from trading on that information or disclose the information before trading.<sup>28</sup> This parity of information rationale, however, was short lived. In *Chiarella v. United States*,<sup>29</sup> the Supreme Court held that the disclose or abstain rule applied only when there was a preexisting fiduciary relationship with investors. The Court believed this relationship exists only through the defendant's fiduciary status in the corporation whose shares he trades. Thus, Vincent Chiarella, a markup man employed by Pandick Press broke the secret code his employer used to conceal the identity of its clients' takeover targets. Chiarella used his knowledge of which firms were to be taken over to purchase the target companies shares prior to a public announcement of their takeover. Justice Powell, writing for the majority, rejected the lower court's invocation of the parity of information reasoning that "*anyone*—corporate insider or not—who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty to disclose."<sup>30</sup> The Supreme Court held that because Chiarella's fiduciary relationship was with Pandick Press and the bidder corporation, he did not have a duty to disclose to the target company shareholders before he traded.

As the facts of *Chiarella* itself demonstrate, many individuals have relationships which afford them an unerodible advantage to inside information vis-a-vis investors generally. It is not surprising, therefore, that the vigorous dissent of then Chief Justice Burger in *Chiarella* set the stage for a far broader theory upon which to delimit wrongful insider trading, the theory of "misappropriation" of another's property. Thus, in the wake of *Chiarella*, American courts have repeatedly upheld insider trading charges where the evidence is that an employee or agent has made an unauthorized use of his employer's information by trading in another corporation's securities on the basis of such purloined information.<sup>31</sup> In one respect, the misappropriation theory can be seen as a natural analogue to *Chiarella's* emphasis of an antecedent fiduciary relationship. There can be no clearer breach of a fiduciary obligation than the unauthorized use of the principal's property for the agent's private venture. This is especially so when the agent's trading poses a threat to his employer's interests. So reasoned, the misappropriation theory is consistent with the justification offered above for the regulation of insider trading; it was advanced earlier that insider trading poses a harm because

---

<sup>28</sup> *Id.*, at 848.

<sup>29</sup> 445 U.S. 222 (1980).

<sup>30</sup> *United States v. Chiarella*, 588 F.2d 1358, 1365 (2d Cir. 1978).

<sup>31</sup> See e.g., *United States v. Carpenter*, [1986 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 92,742 (2d Cir. 1986), *aff'd*, [1987 Transfer Binder] *Fed. Sec. L. Rep.* (CCH) 93,423 (U.S. Sup.Ct. 1987) (Court divided evenly, thus affirming lower court decision); *SEC v. Materia*, 745 F.2d 197 (2d Cir. 1984), *cert. denied*, 105 S.Ct. 2112 (1985).

it invades the private property interests in preserving the confidentiality of another's information.<sup>32</sup>

Superficially, section 1002 appears to embody the same concerns that underlie *Chiarella* as well as the misappropriation theory. Section 1002's emphasis is upon the trader's or tipper's connection with a corporate body from whom inside information is obtained. The meaning of insider is defined specifically in subsections 1002(9)(12) wherein insider includes officers, employees, substantial stockholders, or those having a professional or business relationship with the corporate body. The proscription, however, is not broad enough to cover abuses such as in *SEC v. Lund*,<sup>33</sup> wherein a corporate executive, in the course of seeking advice of a friend on a pending corporate transaction, revealed in confidence material inside information. The revelation was not made with the expectation the friend would trade upon it, which, of course, he did. The SEC successfully prosecuted the executive's friend for insider trading. Moreover, there have been instances in America where corporate executives have revealed to their physicians confidential inside information which the physician used.<sup>34</sup> Not only are such lower echelon individuals within the scope of regulation in America, the cases are replete where individuals of this status have aggressively traded on inside information. Expanding<sup>35</sup> the scope of insider trading regulation beyond employees and others in a direct fiduciary relationship to a corporate body would protect the employer's property interest in the confidentiality of its information consistent with the thesis developed earlier that this interest bears the most tangible injury from insider trading. That injury occurs regardless of whether the trading occurs by its employee or by a complete stranger, for in all such cases there is an unauthorized use of another's information.

---

<sup>32</sup> The misappropriation theory, however, does not withstand close scrutiny against the well-recognized purposes of the federal securities laws or, for that matter, the antifraud provision, rule 10b-5 of the Securities Exchange Act of 1934, under which most American insider trading prosecutions occur. The misappropriation theory's efficacy is the protection of the unfairness to employment relations that would otherwise arise if the employee could freely trade on his employer's information. In other contexts, however, the securities laws and especially rule 10b-5 are viewed as intended to protect investors and securities markets from deceptive practices. For example, the U.S. Supreme Court in *Santa Fe Industries Inc. v. Green* held that rule 10b-5 did not apply when the complaint alleged no more than a breach of fiduciary duty or unfair dealings. Uncertainty over the efficacy of the misappropriation theory continues because of the Supreme Court's even division in *U.S. v. Carpenter* respecting whether Winans' misuse of his publisher's confidential information violated rule 10b-5. The Court, however, unanimously upheld the conviction under the mail fraud statute based on a theory of misappropriation.

<sup>33</sup> 570 F. Supp. 1397 (C.D. Cal. 1983).

<sup>34</sup> See e.g., Cohen, "Doctor Is Accused Of Insider Trading On Patient's Data", *The Wall St. J.* at B 7, col. 6, July 27, 1989. This gap in the regulatory scheme of section 128 has already been observed. See, Baxt, R., H.A.J. Ford, G.J. Samuels, & C.M. Maxwell, *An Introduction to the Securities Industry Codes* 253-54 (2d ed. 1982). It should also be noted that neither of these two situations would constitute unlawful tippee trading under section 128(3) because there is no "association" or "arrangement" between the executive and the trading outsiders for the latter to trade.

<sup>35</sup> Section 1002(3) could, for example, be amended to provide that it is unlawful for a person who has received information *in confidence* from an officer, substantial stockholder or one having a professional relationship to a corporate body to trade on that information. This is the approach recently adopted in New Zealand to define what constitutes insider trading. See Securities Law Reform Act of New Zealand, paragraph 4(f).

In contrast with Australia's narrow definition of who is an insider is the pernicious breadth of section 1002's proscription of tipping. Section 1002(5) defines unlawful tipping as the passing on of price sensitive information when one knows or ought reasonably to know it will be the basis of trading. Consider the rather standard practice of high company officials meeting with selected investment analysts to discuss the company's performance and prospects. Frequently information revealed in such discussions is not always public information. This is best illustrated by the facts in *SEC v. Bausch & Lomb, Inc.*,<sup>36</sup> in which Bausch & Lomb and its chief executive officer, Shulman, were prosecuted for negligently revealing to groups of analysts the negative impact that problems with the Bausch & Lomb's "Softlens" product would have on the company's performance. For weeks Bausch & Lomb was hounded by analysts for a definitive statement of the effect recalls and returns of Softlens would have on the firm. Due to fatigue and simple inadvertence, Shulman revealed the firm's internal predictions. This revelation caused a rash of trading by the analysts and, more significantly, their advisees. The SEC's prosecution was unsuccessful, because the court held that mere negligent misconduct was not proscribed by the antifraud provision, Rule 10b-5 under which most American tipping and insider trading prosecutions occur.

Today, the bulwark protecting American corporate executives in factual situations such as *Bausch & Lomb* is provided by the U.S. Supreme Court's holding in *Dirks v. SEC*,<sup>37</sup> where Secrist, a former officer of Equity Funding of America, informed Dirks, an investment analyst, that Equity Funding's assets were fraudulently overstated. In the course of aggressively investigating Secrist's tip, Dirks shared Secrist's revelation with 5 investment advisers who caused their advisees to liquidate more than sixteen million dollars worth of Equity Funding stock before the scandal was publicly disclosed. The Supreme Court held that illegal tipping and tippee trading occurs only when the selective disclosure is deemed to be "improper". The Supreme Court then offered an extremely narrow concept of what constitutes an "improper" tip: a disclosure is improper if the insider tips a relative, tips a friend, or expects to reap a pecuniary gain from the selective disclosure.<sup>38</sup> In reaching this conclusion, the Court demonstrated the pragmatic view that to have held otherwise in *Dirks* would have had a chilling effect on the socially desirable activities of security analysts.<sup>39</sup> On this point, consider the insight of the *Dirks* court:

---

<sup>36</sup> 420 F.Supp. 1226 (S.D.N.Y. 1976), *aff'd*, 565 F.2d 8 (2d Cir. 1977).

<sup>37</sup> 463 U.S. 646 (1983).

<sup>38</sup> *Id.* at 663-64.

<sup>39</sup> Two leading Australian commentators on insider trading have strongly criticized *Dirks* as imposing too narrow a view of what constitutes illegal tipping. Professors Anisman envisions *Dirks*' reasoning being devoted exclusively to a narrow construction of fiduciary law; Professor Anisman fails to heed the *Dirks*' Courts' reasoning of the pernicious effects if analysts could be too easily prosecuted as tippees. See P. Anisman, *Insider Trading Legislation For Australia: An Outline of the Issues and Alternatives* 22, 55, 63-65 (1986). Black also believes *Dirks* offers too limited a definition of tipper and tippee

'Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is common place for analysts to "ferret out and analyze information" . . . and this often is done by meetings with and questioning officers and others who are insiders.'<sup>40</sup> Thus, *Dirks*' brightline standard extends to analysts a license to pursue aggressively corporate insiders for nonpublic information without fear that their success will expose them to charges of insider trading. To be sure, *Dirks* extends its protection beyond the analysts to the corporate insider who makes the selective disclosure to the analysts. This protection merely recognizes the anomaly that would otherwise occur if the analysts conduct in both obtaining the information and trading upon it is upheld as socially desirable, but the person who selectively disclosed it is viewed as worthy of being treated as a felon. Under *Dirks*, the entire process by which the information is released is perceived as socially desirable.

The Australian provisions would appear to protect neither Shulman nor *Dirks*. While section 1002 can be legitimately faulted for regulatory overbreadth on this point, it also seriously underregulates illicit tippee trading. Section 1002(3) does *not* proscribe the trading of tippees where the tip is made to a friend or a relative,<sup>41</sup> as does the *Dirks* standard. Section 1002 accordingly can be seen as both disrupting a natural and desirable flow of information to securities markets and not interdicting traditional insider trading abuses. Symptomatic of section 1002's overbreadth is the excellent study of Professors Tomasic and Pentony that rigorously catalogues that brokers are unaware that the common practice of obtaining selective briefings by corporate officers is within the broad sweep of the predecessor provision, section 128.<sup>42</sup> More generally, Professors Tomasic and Pentony recognized the "terminological confusion" they encountered when undertaking their survey;<sup>43</sup> their study proceeded from no precise definition of insider trading so as to gauge how various groups of professions perceived insider trading. Not surprisingly, many respondents based their reactions upon the notion that insider trading occurred whenever information being traded upon was

---

<sup>39</sup> *continued*

violations. See Black, "Policies In The Regulation Of Insider Trading And The Scope Of Section 128 Of The Securities Industry Code", 16 *Melbourne U.L. Rev.* 633, 658 (1988). Indeed, Professor Black even believes that section 128(3) is misdirected because it compels the regulatory focus to be upon an antecedent "arrangement" or "association" rather than whether the outsiders have an informational advantage not enjoyed by others. *Id.*

<sup>40</sup> 463 U.S. at 662.

<sup>41</sup> Section 1002(3) only reaches a tip made to one with whom the tipper has an "association" or an "arrangement" to deal in securities, a formal economic arrangement present in a personal relationship.

<sup>42</sup> Tomasic, R. & B. Pentony, *Insider Trading Regulation and Law Enforcement in Australia* (1989) 10.

<sup>43</sup> *Id.*, at 9.

not equally available. As seen earlier, this is not only a condition of insider trading, but more generally of dynamic securities markets.

Early in the life of section 128 an attempt was made to provide an edge to its otherwise obtuse objectives in the study commissioned by the NCSC that produced the Anisman Report.<sup>44</sup> Dr Anisman championed the objective of assuring equal access to material information to all market participants.<sup>45</sup> He believed this purpose was generally consistent with the language of section 128, although he offered a few suggestions for how the section could be amended to improve its enforcement. Not surprisingly, Dr Anisman championed continuing the current proscription of tipping liability.<sup>48</sup> It is interesting to observe that Dr Anisman devoted no attention at all to the positive contribution analysts make by their aggressive pursuit of new information from corporate executives.<sup>47</sup> It was just such considerations that persuaded the *Dirks* court to embrace the definition of tipping that it did. On this point and others, the Anisman Report's Achilles' Heel is its unquestioning obeisance to the parity of information principle.

Further evidence of the lack of focus in section 1002 is provided by the attempts of litigants to apply its predecessor, section 128 of the Securities Industries Act, to cases clearly not involving insider trading activity. From these attempts, one's unease about the pernicious breadth of section 1002 is salvaged somewhat by the pragmatic and insightful approach the courts have demonstrated in resolving the cases. Consider *Hooker Investments Pty Ltd v. Baring Bros Halkerston & Partners Securities Ltd & Ors*,<sup>48</sup> wherein insider trading was alleged to occur because an issuer had disclosed nonpublic financial forecasts to a group of underwriters in advance of a new offering of its securities. Similarly, in *ICAL Ltd v. County Natwest Securities Australia Ltd & Transfield (Shipbuilding) Pty Ltd*,<sup>49</sup> suit was brought to enjoin the target of a takeover from disclosing proprietary information to another company; the disclosure was undertaken to attract a higher bid from a new suitor for the target firm. It should be observed that each fact situation falls within section 128's injunction against the selective nondisclosure of price sensitive information to one believed to trade on that information. In neither case, however, was a violation of section 128 found. In *Hooker*, the court resolved the

---

<sup>44</sup> P. Anisman, *Insider Trading Regulation For Australia: An Outline of the Issues and Alternatives* (1986).

<sup>45</sup> Dr Anisman permits one to trade on information produced by his own efforts, provided another person prepared to devote the same effort and skill can also obtain that same information. *Id.*, at 12. Dr Anisman therefore would appear not to protect the analyst who informs a customer that he will soon go public with a recommendation of a particular stock that will cause a significant increase in that stock. See also, Anisman, *supra*, at 28-29 and 54-73.

<sup>46</sup> Anisman, *supra*, at 63-65.

<sup>47</sup> See Hogan, "Insider Trading", 6 *Companies & Sec. L.J.* 39, 47 (1988).

<sup>48</sup> *Aust. Sec. L. Rep.* (CCH) 76,105 (N.S.W. Ct. App. 1986).

<sup>49</sup> *Aust. Sec. L. Rep.* (CCH) 76, 153 (Sup.Ct. N.S.W. 1988).

dispute on the technical defence provided by subsection 128(10), carried forward to current section 1002(11), that no insider trading violation occurs if the insider's opposite trader is aware of the nondisclosure information.<sup>50</sup> In *ICAL*, the court found that the information could become public before the sale because the confidential information was within the court's records. Even though the obviously right result was reached in each of these cases, and thereby indicating that the courts can limit the scope of an intolerably broad regulatory provision, such as the current section 1002, these cases nevertheless further the disquiet one has generally with section 1002 as well as its predecessor 128. Neither opinion appears to offer sufficient insight into what constitutes impermissible trading. In this respect, *Hooker* and *ICAL* do not disrupt the otherwise prevalent view in Australia that insider trading regulation seeks to achieve informational parity among market participants. A far simpler resolution, and one that would have identified the objective of insider trading's regulation in the first place, is to conclude in *Hooker* and *ICAL* that no misuse of the confidential information had occurred; in each case the disclosure was in furtherance of its creator's enterprise's operations and in neither case was that information misappropriated from its creator.<sup>51</sup>

Thus, section 1002 lacks a cohesive whole that is reflected in both the narrowness of its proscription of insiders and the breadth of its regulation of tippers. This no doubt is traceable to the problems inherent in regulation being premised upon the objective of parity of information.<sup>52</sup> America earlier repeated this same mistake. But its case law has evolved to a stage where who is an insider and what constitutes insider trading does not interdict legitimate and socially desirable flows of information. Australia may well reach this same level as its courts have an opportunity to winnow the scope of section 1002. Clarification may well occur more swiftly through the current parliamentary process in which section 1002 is under review. That process may well cure the problems identified above, namely ridding the statute of its narrow proscription of who is an insider and introducing greater certainty as to what constitutes impermissible tipping. The remainder of this paper considers two important substantive issues—the standard of materiality and burden of proof in government

---

<sup>50</sup> It should be observed that former section 128(11) and current section 1002(11) may be viewed as applying only to a government initiated action because they expressly refer to the defense being available only in a "prosecution". *But see*, R. Baxt, *An Introduction to the Securities Industry Code*. However, former section 130(1)(c) and current section 1003(1)(c) similarly condition the private recovery being available to one "who was not in possession of that information".

<sup>51</sup> In this respect, it is reassuring that the *Hooker* court emphasized that insider trading arises when trading occurs on *impersonal* markets and that *ICAL* emphasized that the information had been selectively disclosed for a purpose consistent with the directors' fiduciary obligations, i.e., to obtain for the stockholders a higher price for their shares.

<sup>52</sup> The Cambell Committee that stimulated the need for the Anisman study found that insider trading regulation is justified by a need to assure that all market participants have equal access to relevant information. *Final Report of the Committee of Inquiry, Australian Financial System*, section 21.118 (Sept. 1981).

prosecutions—as well as a reconsideration of Australia's overall mechanism for enforcing its insider trading laws.

### III. THE DEFICIENCIES AS PERCEIVED BY THE NCSC

The NCSC was on the defensive for some time as to why it has not been able to produce an insider trading prosecution. Indeed, as of the writing of this article, the NCSC had not yet achieved a successful prosecution for insider trading, although it finally does have a few insider trading cases in litigation. The NCSC is on record<sup>53</sup> as believing its enforcement efforts are seriously hobbled by section 128's requirement that the information "would be likely materially to affect the price" of the securities traded.<sup>54</sup> This requirement is not changed in newly enacted section 1002(1) and (2). In America, the question of materiality is a joint question of law and fact determined under the standard test of whether the reasonable investor would consider the fact important in deciding whether to trade in a security. The U.S. Supreme Court has further liberalized this standard by stating that a fact is material even though it does not alter the investor's decision to purchase or sell; it is sufficient if there is a substantial likelihood the information would have assumed actual significance in the reasonable investor's deliberations.<sup>55</sup> At first blush, it would appear that Australia has a more demanding standard, and certainly this was the belief of the NCSC, because it requires proof of the information's likely affect on a security's price. Thus, the distinction between the American and Australian standard would be the former's emphasis on the hypothetical reasonable investor's deliberative process whereas in Australia it is a more focused inquiry upon the information's impact upon a particular security's price. The NCSC complained earlier that former section 128 burdened its prosecutions with the necessity of securing expert witness testimony of the information's likely impact. A close observer of insider trading cases, however, would find little difference, forensic or otherwise, posed by the two different articulations of materiality.

American insider trading prosecutions have not been hindered by findings that the information within the defendant's possession was not material. The essence of insider trading is that a defendant *has in fact profited* by advance knowledge of an event or announcement that will change a security's price. No insider trading prosecution has been initiated against the "bumbling" inside trader who has secretly traded on information of no economic significance whatever. Indeed, inside trading would never come to the attention of investigators; if it did, it would

---

<sup>53</sup> NCSC Submission to Joint Select Committee on Corporations Legislation, *Insider Trading* 3. See also, Black, *supra* at 651.

<sup>54</sup> Securities Industries Act section 1002(2)(a).

<sup>55</sup> *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).



certainly suggest misguided enforcement priorities. Certainly in America, insider traders make money and one would expect this to be true elsewhere.

Furthermore, it is not at all clear that expert testimony is either necessary in all cases or even burdensome to produce when required. For example, in *Texas Gulf Sulphur*, the very fact that once the defendants came into possession of information about the company's single core drilling, indicating a startling discovery of zinc, copper and sulphur, they traded in their company's stock was relied upon by the court to establish that the information was material. In other cases, the best indicator of materiality is how the market responded to the information once disclosed. An observable price movement in connection with the information's disclosure is far more reliable than direct testimony procured by embattled counsel. Finally, expert testimony on the information's impact is not burdensome to acquire and in America has not been a troublesome part of the prosecution's case. If doubt exists about the ease by which materiality can be established under section 1002, this should be removed by review of *Kinwat Holding Pty Ltd Ors v. Platform Pty Ltd*<sup>56</sup> wherein the court, considering the predecessor section 128(2), concluded without the aid of expert testimony that confidential information was "price sensitive". In sum, any deficiencies within section 128 that prevented its effective enforcement cannot be attributable to that provision's requirement that the information's likely effect on a security's price must be established.<sup>57</sup>

Government regulators have also expressed the view that their obligation to establish a violation "beyond a reasonable doubt" seriously impedes their enforcement efforts.<sup>58</sup> However, a significant portion of America's prosecution of insider trading occurs within the criminal justice system where the violation must not only be proven to be "willful" but that proof must be beyond a reasonable doubt. That high standard has not been a problem in such criminal cases. Insider trading cases are by their nature not instances of inadvertent violations. The U.S. Congress recently rejected pressures to define insider trading; in that rejection was the belief that defendants are fully aware of the nature of their violation since the crime is that characterized by great efforts at secrecy, stealth and calculated efforts. So viewed, it is difficult to believe that enforcement efforts are crippled by the government's obligation to establish its case beyond a reasonable doubt. Furthermore, the regulators would have a

---

<sup>56</sup> [1980-82 Transfer Binder] *Aust. Sec. L. Rep.* (CCH) 76-012 (Sup.Ct. Queensland 1982).

<sup>57</sup> Also, Australian courts have reached the same result as their American counterparts in holding that information can be price sensitive, even though the information is not "specific", but is in fact deduced from other information and there is doubt whether the deduced information is in fact correct. See, *C.C.A. v. Green*, 1978 V.R. 505, 29 A.C.L.C. 778 (1978), 3 A.C.L.R. (1978).

<sup>58</sup> The NCSC's Chairman reported to the House of Representatives Standing Committee on Legal and Constitutional Affairs that 72 out of 108 insider trading inquiries in recent years were written off because of the staff's belief that it could not prove a violation beyond a reasonable doubt. Gill, NCSC admits defeat over efforts to nail 'insiders', *Financial Rev.* at 3, col. 2-3, May 10, 1989.

better case if their record was replete with prosecutions commenced but unsuccessful because of the inability to persuade the trier of fact. But as seen, Australian regulators have just recently initiated their first insider prosecutions. The suggestion therefore is that the problem exists within the structure of enforcement efforts, rather than any particular elements of the prosecution's case. The balance of this paper examines the Australian enforcement structure against the American experience.

#### IV. THE ECONOMICS OF PUBLIC PROTECTION OF PRIVATE INTERESTS

The forgoing review leads to a seemingly precarious foundation for insider trading regulation. The central concern developed above is that insider trading regulation cannot be justified in the interest of protecting investors or securities markets, but rather the property interest in the information's confidentiality.<sup>59</sup> An even more profound jurisprudential issue arises when one considers the possibility that insider trading can be criminally sanctioned. And there is the anomaly that even though contemporaneous traders appear, under the above analysis, not to have incurred any harm by the fortuity of the insider's trading, they nevertheless enjoy a private right of action against the inside trader. Each of these anomalies are present not only in New Zealand, but also in America whose rich experience in dealing with insider trading provides some insights into how such anomalies are rational mechanisms for the protection of another's property interests.

##### A. *Centralized Enforcement*

Private litigation has not been a necessary or even an effective weapon in the detection or deterrence of insider trading in America. To be sure, in other areas of the American federal securities laws, the class action and contingency fee devices are indispensable to assuring compliance with disclosure requirements of the federal securities laws. In the case of insider trading, however, nearly all cases initiated are by the government.<sup>60</sup> Occasionally the publicity surrounding such government prosecutions stimulate collateral private actions. These suits are parasitic because they not only free ride on the government's evidence, but more frequently seek to share in any profits the government's successful prosecution has wrested from the defendant. Moreover, the government

---

<sup>59</sup> This feature of insider trading regulation is illustrated by American developments under which the proscription is based on the notion that the insider stands in a fiduciary relationship to those in the market and hence owes a disclosure duty before trading, *Chiarella v. United States*, 445 U.S. 222 (1980). *Chiarella* was immediately perceived as not providing a sufficiently encompassing disclosure duty, so that the prevalent theory today is that of misappropriation of another's information. See e.g., *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). Under the misappropriation theory, "unfairness" to employment relationships that occurs by unauthorized use of the employer's information is emphasized and not deception of investors. See e.g., *SEC v. Materia*, 745 F.2d 197, 201-02 (2d Cir. 1984).

<sup>60</sup> Dooley, *supra*.

has won a series of decisions upholding the power of the courts to order broad ancillary relief incident to the government's prosecutions; the effect is that government proceedings frequently result in a mechanism for substantial awards being paid to private parties.<sup>61</sup>

That America's enforcement of insider trading is so centralized is a natural effect of the offence. Insider trading is an offence of stealth; its presence generally is detected only by first observing unusual trading activity in advance of a public announcement of an economically significant event. Hence the government's enforcement efforts are heavily dependent upon electronic market surveillance. The paramount role that such market surveillance plays in the enforcement effort and the actual operation of that system assures the efficacy of public enforcement of insider trading regulation in America. Because the same process will surely evolve in Australia, it is useful to briefly describe the electronic surveillance system superintended by the various American self-regulatory<sup>62</sup> organizations.

The self-regulatory organizations monitor trading activity through sophisticated computers that can identify abnormal price or volume changes within seconds of their occurrence. Once such trading abnormality is detected, wire releases are reviewed to determine whether the trading activity can be explained by market, industry or company specific information. If nothing appears from a perusal of the various wire services available to the organizations, the subject company is contacted to determine if there is a corporate event not yet announced. The organizations also perform a retrospective review of trading in listed company's stock for possible abuses before an announcement was made. Once suspect trading is identified, the self-regulatory organization's investigators move into the second stage whereby the brokerage firms executing the suspect transactions are identified and later a profile of their trading customers is prepared. This information is screened through the Automated Search and Match System (ASAM) to determine the trader's relationship, if any, with the listed company. ASAM's data base includes the names and general information for over 500,000 corporate officers, directors, attorneys, accountants, and other individuals having corporate contacts. The screening can also look for characteristics common to both a suspect trader and another person who appear within the ASAM data base. For example, the investigator's suspicions are increased when the trader's alma mater or club affiliation match those of the issuer's executive. And, of course, investigators use simple old fashion investigative questioning to determine if insider trading occurs. When the investigators believe insider

---

<sup>61</sup> See Ellsworth, "Disgorgement in Securities Fraud Actions Brought by the SEC", 1977 *Duke L.J.* 641 and Farrand, "Ancillary Remedies in SEC Civil Enforcement Suits", 89 *Harv. L. Rev.* 1779 (1976).

<sup>62</sup> The involved organizations are the seven national and regional exchanges as well as the National Association of Securities Dealers.

trading has occurred, they forward their evidence to the government prosecutors.

From the above description, it can be seen that centralized enforcement of insider trading enjoys something akin to a natural monopoly. Because its presence can in most instances only be observed initially from a close inspection of abnormal trading and because such inspection requires both an elaborate investment in computers and manpower, it is not reasonable to expect detection to occur other than by some centralized means. To be sure, not all insider trading cases have come to the government's attention through the use of sophisticated computer surveillance.

The reliability of contemporary computer surveillance techniques was seriously questioned by a review of the massive insider trading activity of Mr Dennis Levine. In 1985, the New York Stock Exchange surveillance staff directed to the Securities Exchange Commission 11 different reports of questionable trading practices occurring through the Bank Leu; however, this suspicious trading pattern did not lead to a prosecution by the SEC because there was insufficient collaborative information. Later, Merrill Lynch Pierce Fenner and Smith, a brokerage house, after receiving an anonymous tip, presented evidence to the SEC which connected Dennis Levine with the Bank Leu.<sup>63</sup> The investigation of Mr Levine's trading revealed a pattern of insider trading abuses going back to at least 1980. The United States Congress, reacting to the Levine experience, has attempted to augment America's detection and prosecution of insider trading cases by providing a bounty award of up to 10% of the government recovery for those who assist the government's detection of insider trading.<sup>64</sup>

The foregoing review of the processes for detecting and prosecuting insider trading, as well as compensating investors, presents a very unique and harmonious public and private partnership. While the utilization of the public prosecutor to provide private relief may strike many as highly novel, history nevertheless records that even the early English criminal courts were a joint enterprise between the victim and the government. The victim served as prosecutor and shared with the state any fine resulting from a successful prosecution.<sup>65</sup> Today in America, much the same occurs in the prosecution of insider trading: whether the government prosecution is criminal or civil, the remedy frequently includes restitution to those believed injured by the insider's conduct. In light of the natural efficiencies

---

<sup>63</sup> See *Hearings on Insider Trading before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee of Energy and Commerce*, House of Representatives, 99th Cong., 2d Sess. July 23, 1986.

<sup>64</sup> The Insider Trading and Securities Fraud Enforcement Act of 1988 amended section 21 A(e) of the Securities Exchange Act, 15 U.S.C. 78 to provide for this award.

<sup>65</sup> 2 Pollock & Maitland, *History of English Law* 449-462 (2d ed. 1898).

concomitant in the detection of insider trading, the centralized prosecution is also an efficient response.

Enforcement of section 128 was divided between the NCSC and the state Corporate Affairs Commissions. The division reflects the recurring tensions of Australia's federalism; those tensions are exacerbated by the uncertainty regarding the breadth of the Commonwealth government's constitutional authority over corporate and securities law matters.<sup>66</sup> The division does not necessarily interdict effective enforcement, because in America prosecutions are divided between the SEC's division of enforcement and the numerous U.S. Attorney Offices in which the former handles all civil actions and the latter criminal prosecutions for insider trading. The history of this division of authority is characterized by cooperative investigative efforts of both groups. If there was a problem with the jurisdictional division in Australia during the NCSC's era it appears to be a problem of dividing too few resources<sup>67</sup> over too many offices, not a lack of cooperation between the NCSC and CACs.

By almost any comparison, the NCSC's resources were woefully inadequate for the many tasks assigned to the agency. With a staff of 82 at the close of its 1988 fiscal year, its task included the vigilance for thousands of Australian corporations subject to its enforcement of securities and company law provisions, policing nearly 25,000 dealers and investment representatives, and as well carrying on both a dialogue with the emerging Australian Stock Exchange and various regulatory and legislative bodies involved with company and securities law issues. Its superintendence of these tasks occurred on the rather slender budget of less than \$6 million.<sup>68</sup> The poor staffing and budgetary support problems hopefully will not be repeated with the newly created Australian Securities Commission; there has been much discussion that the new agency's staff, especially its enforcement personnel, will be substantially larger than that of the NCSC.

It should also be observed that the common intractable questions concerning federal-state powers<sup>69</sup> are not raised by centralizing enforcement of market abuses, such as insider trading, in a single federal

---

<sup>66</sup> See e.g., French, "The New Australian Co-Operative Company and Securities Scheme", 8 *The Company Lawyer* 51 (March 1987); Pascoe, "Whither Co-Operative Federalism?: An Analysis of the Commonwealth Government's Plan for Unilateral Companies Securities, and Futures Legislation", 6 *Company and Sec. L.J.* 148 (Aug. 1988).

<sup>67</sup> It remains to be seen whether the recent announcement of a 50 per cent increase in staff for the NCSC is a step in the right direction, *Sydney Morning Herald*, March 3, 1989 at 5. Moreover, there has been a report that a substantial augmentation in the market surveillance equipment is imminent. Whether these enhanced enforcement resources will accomplish their intended goal is a question that deserves to be monitored closely.

<sup>68</sup> NCSC, *Ninth Annual Report and Financial Statements* 41, 54, 62 (1988).

<sup>69</sup> A good summary of these arguments appear in Baxt, "Editorial", 6 *Company and Sec. L.J.* 1-2 (Feb. 1988).

agency. Such centralization does not evoke fears that Canberra will exercise too much power over commercial transactions, or that too much discretion will be granted to remote bureaucracies, or that the states will lose important revenue sources. In sum, the centralized policing of securities markets does not evoke the same political issues as does concern about who should have control over company law and the registration of new offerings. And, because the preceding description identifies natural efficiencies inherent with centralization of insider trading regulation, a compelling case exists for centralizing enforcement in a federal body, such as the NCSC.

The question to be answered is whether the lack of successful prosecutions to date is a problem exclusively of insufficient resources or instead is a misdirection of enforcement efforts. From the past experiences under the NCSC helpful lessons can be learned which may prove useful in strengthening the regulatory record of the newly created ASC. The NCSC was no doubt crippled by the structure surrounding its oversight as well as its relationship with the CAC's. This statement implicates what the author believes was a very serious structural problem with the Australian regulatory framework, namely the problem of the NCSC's accountability. That structure was flawed because oversight of the NCSC was not designed to assure accountability to federal enforcement interests. One of the most anomalous aspects of Australia's regulation of securities markets during the NCSC's era was that the federal government provides one-half of the funding for the NCSC, but it appointed only one of the eight ministers that oversee the NCSC through the Ministerial Council. Thus, the governmental bodies with the least financial investment in the cause of regulation have the greatest oversight role; whereas, the body with the most financial investment has hardly any permanent oversight function. As discussed earlier, market frauds, such as insider trading, are uniquely national in their scope, especially given the interconnection that exists among the Australian markets. However, the structure of the oversight that occurred during the NCSC's era when it was the principal enforcement agency appears to have been poorly designed to assure that the agency was sensitive to national, rather than provincial, interests.

The enforcement of section 1002 takes on a questionable dimension in section 1013(1)(c)'s provision of a private cause of action for those whose trading can be matched with the insider's purchase or sale. There are several reasons to believe this is an ill-advised enforcement medium. First, as developed earlier, contemporary market participants are not harmed by the insider's *trading*; for the innocent investors, the insiders trade is a mere fortuity. Second, section 1013(1)(c) allows such contemporaneous traders to recover no more than the gains the insider garnered (or the loss that he has thereby avoided). On close analysis, this restricts the defendant's liability to private litigants to the defendant's illegal gains because his total liability is bounded by the number of shares

traded with him and the measure of recovery is the gain made or loss avoided per share. Certainly this is an insufficient disincentive to illegal trading because the insider is hardly worse off if he trades and is reprimanded only for his illicit gains than if he foregoes trading and thereby reaping an illicit gain. Any sanction designed to deter insider trading must substantially exceed the insider's illicit gains. Hence, the wisdom of the American Insiders Trading Sanctions Act that permits the SEC to recover up to treble the defendant's profits. A third concern is the natural economic disincentives for private action against insider trading. As seen, the amount the private litigant can recover in Australia cannot exceed the insider's illicit gains. Unless the plaintiff's transaction with the insider involves an extremely large number of shares, the plaintiff's litigation costs, such as attorneys fees, will overwhelm the expected recovery. If no individual investor has lost an amount sufficient to justify bringing the action, private enforcement will not occur. America overcomes this problem by both the class action and contingency fee devices. This not only allows large numbers of small claims to be joined together to make the suit economically advised, but the contingency fee device overcomes the natural risk aversion of such small investors. In combination they provide a vehicle for the private prosecution of securities law violations. As seen, in the insider trading area, such private class actions have not played an important enforcement role. This is partially due to the ability of government actions to obtain ancillary relief that provides private remedies within the government prosecutions. The Australian provisions are particularly deficient in their remedies. The ASC has authority under section 1013(3) to wrest limited ancillary remedies, having only the power to recover the amount that private litigants could have recovered, i.e., the profits made by the defendant,<sup>70</sup> but the criminal and civil sanctions the ASC may impose are woefully inadequate to provide any deterrence.<sup>71</sup>

### ***B. Sanctions, Employers and Self-Regulatory Organizations***

Enforcement mechanisms are not the only factor relevant to deterring insider trading. The nature and extent of the penalties imposed are also important. The SEC has since 1984 had authority under the Insider Trading Sanctions Act to seek civil penalties up to treble the insider trading profits

---

<sup>70</sup> The orders the Commission is empowered to obtain under sections 1114 and 1324 of the Corporations Act include orders to restrain a violation or the disposal of a security, to appoint a receiver, to avoid a contract, to secure compliance with an order, or any ancillary order to carry out any of the before mentioned types or orders. The NCSC had equivalent powers under s. 14 of the Securities Industry Act and s. 574 of the Companies Act, apart from the power to take representative proceedings now conferred by s. 1013(3).

<sup>71</sup> It is possible for a defendant to be sentenced to up to 5 years in jail for insider trading or be required to pay a fine of \$20,000: Corporations Act, Schedule 3. It remains to be seen whether this penalty will ever be imposed. The criminal penalty of \$20,000 regardless of the amount of insider trading profits is clearly an inadequate public sanction.

against persons who commit insider trading violations.<sup>72</sup> This provision was recently amended<sup>73</sup> so that it now exposes brokerage houses and investment advisory firms to the treble sanction if their employees have committed an insider trading violation and the employing organization is found to have failed to take appropriate steps to prevent insider trading violations. Specifically, the civil sanction applies where the employing organization has failed to take appropriate action once aware of, or in reckless disregard of circumstances indicating, a likelihood that an employee was engaging in an ongoing insider trading violation or was about to engage in such a violation.<sup>74</sup> Importantly, the government has an alternative route to imposing the treble profit sanction upon an employer. Instead of establishing that the employer had knowledge or was reckless in the face of another's violation, the employer can be so sanctioned if it "knowingly or recklessly failed to establish, maintain or enforce" the policy and procedures "reasonably designed to prevent the misuse of material, nonpublic information" and "such failure substantially contributed to or permitted the occurrence of" insider trading.<sup>75</sup> The expanded liability for employers operates in tandem with amendments to the Securities Exchange Act<sup>76</sup> and Investment Advisers Act<sup>77</sup> which impose upon broker-dealers and advisers an affirmative duty to institute, maintain and enforce a reasonable and proper system of supervision, surveillance and internal control to protect against insider trading violations by its employees.

By expanding civil sanctions to employers, the Congress recognized that civil sanctions will increase the economic incentives for employers to supervise vigorously their employees. Such organizational efforts are seen as a desirable concomitant to public enforcement efforts. In this respect, centralized insider trading regulation has been augmented by the dispersed efforts of others. To be sure, the recent American legislative provisions imposing obligations on employers to police their employees reflects Congress' waning patience with the frequency of insider trading among market professionals; this legislative provision also reflects the view that the marginal returns of further centralized efforts are not nearly as great as enhanced efforts by employers who enjoy an especial position to curb the errant acts of their employees.

Australia places very little responsibility upon employer organizations to join the cause of insider trading regulation. What evidence

---

<sup>72</sup> Section 21(d)(2)(A) of the Securities Exchange Act, 15 U.S.C. 78 (qq) (1984).

<sup>73</sup> Insider Trading and Securities Fraud Enforcement Act of 1988. [Hereinafter reference to changes introduced by this act are to their designation within the Securities Exchange Act or Investment Advisers Act.]

<sup>74</sup> Section 21A(b)(1)(A).

<sup>75</sup> Securities Exchange Act section 21A(b)(1)(B).

<sup>76</sup> Securities Exchange Act section 15(f).

<sup>77</sup> Investment Advisers Act section 204A.



there is of the responsibility of employers to be concerned with insider trading arises indirectly through the Code's embrace of the "Chinese Wall" defence. This provision shields an employer from responsibility when an employee is in possession of material inside information, if evidence exists that that employee was sufficiently separated from his employer's trading in that same security.<sup>78</sup> To be sure, the codification of this defence will encourage employers to assure that their trading is immunized from insider trading by procedures designed to shield their trading activity from informational leakages from its other business operations. But the incentive to develop Chinese Walls does not go further to encourage Australian employers to detect illegal tipping and trading by their employees. In view of the limited enforcement resources available to the government, it is reasonable to conclude that increasing the surveillance and protection obligations of private employers would be a very cost effective approach to the regulation of insider trading. In this respect, the American scheme deserves thoughtful consideration by Australia's parliament.

It should also be observed that orthodox standards of vicarious responsibility to not expose the employer to responsibility for its employees' insider trading violations. To be sure, section 1002 does reach the employing organization where those in command of its trading strategy cause the organization to deal in a security on the basis of nonpublic price sensitive information. But the ultimate objective of imposing employer responsibility in America was to reduce the incidence of insider trading in cases where the trading was not part of the employer's enterprise, but quite separate from it. In these cases, normal patterns of vicarious liability impose no responsibility upon the employing organization because the insider trading was beyond the employee's scope of employment.<sup>79</sup>

Professors Tomasic and Pentony report the widely held belief that insider trading is prevalent among brokers. As discussed earlier, this may reflect not so much the prevalence of insider trading but instead may document too broad a view of what constitutes insider trading. Nevertheless, it is significant that the sole government insider trading prosecutions to date have involved the trading of brokers. Moreover, brokers have been over-represented in insider trading prosecutions in America. In combination, there is at least cause to question regulatory measures in addition to direct penalties upon the inside trader himself. One can find within the current regulatory framework of the Australian stock exchanges the potential for that self-regulatory organization to have a proactive role in the regulation of insider trading.

No new stock exchange can exist without the approval of the Minister,

---

<sup>78</sup> Section 1002(7) Corporations Act.

<sup>79</sup> See e.g., *SEC v. Sorg Printing Co., Inc.* [1974 Transfer Binder] *Fed. Sec. L.Rep.* (CCH) 95,034 (S.D.N.Y. 1974).

on the recommendation of the ASC.<sup>80</sup> Among the conditions for approval is that the exchange's rules must make satisfactory provision for the expulsion, suspension or disciplining of its members for, among other offences, conduct inconsistent with the provisions of the Corporation's Act.<sup>81</sup> The Minister and the ASC, however, lack powers comparable to those enjoyed by their American counterpart, the SEC, which can add, repeal or amend the rules of any registered exchange. The power of the Minister is exercised primarily at the stage of an exchange's initial application; thereafter the power can be exercised only with respect to reviewing precise changes within that exchange's rules.<sup>82</sup> The hand of the government, therefore, is a weak one in terms of imposing any regulatory role upon an established stock exchange.

The exchanges themselves can exercise great influence over the professional mores of their members and their members' employees. Their internal rules and standards are in the nature of a contractual obligation binding upon all its members; internal procedures exist by which the exchange's governing committee can discipline noncomplying members.<sup>83</sup> Moreover, the ASC has the power to obtain an order against a broker licensed by an exchange who has in connection with trading or dealing contravened the exchanges rules for licensing.<sup>84</sup> The structure therefore exists, if the exchanges so wished to exercise it, to impose the type of surveillance and preventive measures recently imposed upon American broker-dealers and advisers. To date, however, the Australian exchanges have no such requirement.

The Corporations Act requires that dealers, advisers and many of their employees must obtain a license before practicing their profession.<sup>85</sup> However, the ASC lacks authority to condition its award or renewal of a licence upon the licensee maintaining its internal operations in a way so as to reduce the possibility of insider trading.<sup>86</sup> Indeed, unless insider trading is viewed as an offence involving "fraud or dishonesty" the ASC lacks the power to revoke a licence for insider trading.<sup>87</sup> In sum, the ASC has a very weak position vis-a-vis either the exchanges or broker or adviser organizations to mandate the type of surveillance procedures

---

<sup>80</sup> Corporations Act, s. 769.

<sup>81</sup> Corporations Act, 769(2)(iii).

<sup>82</sup> Corporations Act, s. 774.

<sup>83</sup> See generally, Baxt, R., H.A.J. Ford, G.J. Samuels & C.M. Maxwell, *An Introduction to the Securities Industry Codes* 83-92 (2d ed. 1982).

<sup>84</sup> Corporations Act, s. 1114.

<sup>85</sup> Corporations Act, ss. 780, 781.

<sup>86</sup> The award and continuance of a license is dependent upon the licensee not failing financially, being convicted of a fraud, becoming insane, or failing to file its annual report. Corporations Act, s. 825, 826.

<sup>87</sup> Securities Industry Act 59(1)(a)(ii). On the other hand, the violation of any provision of the American federal securities laws is grounds for a broker being disciplined under section 15(b)(4) of the Securities Exchange Act.

now incorporated in the American legislation. If these powers are to be held, they will, as in America, have to occur by specific legislative enactment.

## V. CONCLUSION

Australia's regulation of insider trading needs to be seriously reconsidered. Its definition of insider trading should be broadened to extend the maximum protection to the property interests of the information's owner. At the same time, it threatens corporate executives with prosecution for tipping if they wish to maintain an orderly dialogue with the investment community. But the greatest problem appears to be within the structure of enforcement. In the NCSC, Australia created an agency with a low level of accountability to its federal government. Such a structure was very much out of step with the view developed in this paper that insider trading is a national offence, calling for responsive centralized enforcement efforts. The current structure provides that the ASC is the federal agency responsible to the Commonwealth so that now the principal enforcement body is totally accountable to the body that nurtures its activities. Nevertheless, the sanctions available to the ASC continue to be too modest to provide any meaningful deterrence to insider trading. Private actions by injured investors are unlikely to occur and when they do occur they will remove no more than the insider's illicit gains. Certainly the cause of deterring insider trading will be much improved by empowering a strong central enforcement body to recover more than the defendant's illicit gains and to empower the courts to provide ancillary relief where appropriate to compensate those proximately harmed by the insider's misconduct.