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Subject: Insic

John

Ive just finished reading the insider trading report. Im not authorised to proffer any comments on behalf of ASIC, so Im simply providing private comments on 2 aspects of the report that I feel could be further illuminated.

Reporting by Directors

First, in relation to s205G (para 3.3), prior to the FSR Act, the view was held that trading in company issued options prior to exercise was not required to be disclosed. This stems from the long held view that company issued options were not securities under the previous s92 as they were not units of shares the shares being unissued.

Although company issued options are now (post FSR) securities under the definition in s761A (for the purposes of Ch7), it is not apparent to me that the definition in s92 has cured this defect. Although the definition excludes derivatives, and in turn it is noted that company issued options are not within the definition of "derivative", Im not sure this brings company options into the definition because they are still not units of shares. In fact, the definition in s761A seems to acknowledge that company issued options do not amount to such.

Time of ASX Transactions

Second, in relation to **Mt Kersey** (para 3.42), I attach a copy of a newsletter prepared by SMARTS, an organisation associated with Professor Mike Aitken-see www.smarts.com.au. In my view, this synopsis usefully discusses the mischief of the Mt Kersey case. Essentially, although the legal reasoning underlying that case appears to be technically correct by reference to the question of when a contract is formed on ASX, its mischief is that traders with inside information can place orders on SEATS and providing those orders do not trade, there is no contravention. The mischief of that practice is that those orders gain time priority on SEATs and that destroys the integrity of the market. The paper does not seem to discuss the issue of time priority, and thus the ultimate conclusion in para 3.46 that noone suffers detriment until an offer is accepted is flawed because persons who would otherwise have had time priority do not when a person with inside information is permitted to place an order on SEATs providing the order does not trade.

Moreover, in my view, it is not anomalous that a person can be liable where no trading takes place (para 3.44). As I apprehend it, communication is contrary to s1043A, whether or not trading takes place.

Further, you might recall that in the **Nomura** case, Nomura argued that there could be nothing misleading about Nomura's conduct until its strategy was put in place. Save for the two self-trades which actually occurred, the strategy was never implemented. Section 998(1) could not be read as covering mere attempts. Sackville J responded that

Nomura, in placing the Bid Basket and giving instructions for the March Sale Orders, engaged in conduct intended to create a false or misleading appearance of active trading on the ASX in illiquid securities held by it on 29 March 1996. It also engaged in conduct intended to create a false or misleading appearance with respect to the price of illiquid securities held by it on the same day. Nomura's conduct therefore contravened the second limb of s 998(1) of the *Corporations Law*. This aspect of Nomura was upheld by the NSW Court of Criminal Appeal in **OHalloran.**

By parity of reasoning, it might be argued that where an insider places an order on SEATs and gains time priority (with the benefit of inside information), that person is contravening s1041B as traders who place orders after that person act on the assumption that that person is acting on the basis of all of the information in the market, when in fact they are privy to inside information. Those cases also demonstrate that civil/criminal consequences can flow, whether or not a trade is effected.

Issue 7- Mt. Kersey Mining Case

This issue of Discovery examines a recent insider trading case in Australia. The case was dismissed by the judge, however, it raises a number of interesting issues for securities market organisers and regulators.

Facts of the Case

The facts of the case are obtained from a number of Australian Financial Review articles that appeared on 17, 18 and 20 November 1999.

On 21 November, 1995 the Australian newspapers reported what was believed to be the highest grade nickel discovery ever. The discovery was made in Kalgoorlie, Western Australia. The discovery was important because it was made on a tenement next to one owned by Australian listed company Mt Kersey Mining.

News of the discovery, however, was far from new. A private company, Mining Project Investors ("MPI"), made the discovery in May 1995. However, as a private company, MPI was under no obligation to report this information publicly. Therefore the information remained generally unavailable.

Prior to the release of the information, Alan Evans, Finance Director of MPI formulated a plan to purchase stock in Mt Kersey shortly after the information was released to the public. The plan involved briefing a journalist at 14:00 on 20 November followed by a news release that was to be faxed to journalists, investment advisors and people associated with MPI. Evans also instructed a broker, at a Melbourne stock broking house, to purchase 166,000 shares in Mt Kersey after 14:00 on the day of the announcement.

However, the plan did not run smoothly. The journalist arrived 30 minutes late and as a result the press release was not faxed until 14:49. Unaware of these delays, Evans called the broker to request that he delay the purchases until after 14:30. He reportedly changed the timing of the purchases in order to allow 30 minutes for the information to be disseminated to the market.

The broker then began purchasing stock on behalf of Evans at 14:31, prior to the dissemination of the information to the Australian Stock Exchange (ASX) or any other party. At 14:34, the broker announced the details of the MPI nickel find to other dealers at his firm. This resulted in significant buying from other clients of the broking house. At the close of trading the price of Mt Kersey had risen by 29 percent and the daily turnover was four times higher than average. This unusual trading behaviour precipitated a lengthy investigation by the Australian Securities and Investment Commission (ASIC). This investigation culminated in charges being laid against Evans and the dealer. The ASIC viewed this as a test case to establish the boundaries of Australia's insider trading laws

Importance of the Case

The Mt Kersey case was important for a number of reasons. First, the ASIC hoped to establish that a person with no legal relationship to the company could be considered to be an insider when in possession of price sensitive information, which was not generally available. This would have made the scope of Australia's insider trading laws wider than most other jurisdictions. Many jurisdictions still require that a duty of care or fiduciary relationship exist between the trader and the company in which they are trading.

Second, the dealer was the first person to be charged with insider trading without having personally profited from the activity.

Third, Evans was the first person to be charged with insider trading while acting as a director of a company which was not required by law to announce their results to either the ASIC or ASX. The case offered an opportunity to test whether insider trading can take place when non-public information about a private company could affect the price of a listed company.

Finally, the fact that Evans intended to wait for 30 minutes after the release of the information before he traded raises a number of additional issues which could have tested by this case. Recall from Discovery 6 that the Australian insider trading provisions require that a person trades on the basis of information that is not generally available. It also requires that parties do not trade until a "reasonable period for it to be disseminated" among "persons who commonly invest" in the stock has passed. None of these terms have been clearly defined in the law and will remain ambiguous until tested. Perhaps 30 minutes was sufficient time for the information to be disseminated to persons who commonly invest in Mt Kersey. If this is the case, then Evans and the dealer had no case to answer

Outcome of the Case

The Mt Kersey Mining case had the potential to test the boundaries of insider trading laws in Australia. However, it failed to do this as it was dismissed on a technicality.

The judge dismissed the case because the prosecution had based the case on the wrong time.

The prosecution took the view that there was an agreement to buy shares when the client placed the order with the broker. However, the defence argued that there was no agreement until the order had actually transacted on the exchange. Despite the fact that this view conflicts with the view of most brokers, the judge agreed with the defence. Further, he ruled that the defence would be prejudiced because the prosecution had based the case on the earlier time and therefore dismissed the case.

Implications

While this decision prohibited the ASIC from testing the boundaries of the insider trading laws, it raised a number of new issues.

First, it suggests the need for clarity in the definition of an agreement to buy shares. The definition accepted by the judge in this case raises new issues for insider trading cases. If an agreement is not made until the transaction takes place, insiders are legitimately able to place orders into the order book, in order to gain time priority[1], before the information becomes generally available. Therefore, they are able to take advantage of their inside information by ensuring that their orders will be executed first, without risking prosecution for insider trading. Clearly, this is not a desirable outcome.

Second, as discussed in Discovery 6, it identifies the need for training of judges to ensure that they are aware of industry practices and behaviour. The definition of an agreement to buy shares accepted by the judge in this case is clearly inconsistent with the view held by industry.

Third, the case also raises questions about whether a judge should have allowed the jury to make a judgement on the facts of the case, despite the procedural problems.

Fourth, it suggests that the defence should be required to outline their approach at the outset of the trial to prevent such procedural errors. In this case, the defence waited until five weeks into the trial before debating the definition of an agreement to trade. Had this issue been identified earlier, the prosecution could have amended its case accordingly.

Conclusion

Finally, questions have been asked as to whether trial procedures should be changed to allow for a retrial if an appeal court finds that the trial judge misinterpreted the law in cases such as this.

Footnote

1. Time priority means that orders at the same price which are place earlier will be executed prior to those which are placed later.

Accordingly, I do not think that an insider should be able to either place an order or trade when in possession of inside information, as both affect market integrity. Placing an order disadvantages other traders in terms of time priority, whilst trading disadvantages the counterparty. At most, instructions could be given to a broker by an insider, as noone is detrimentally affected by that act. However, that may well constitute communication contrary to s1043A(2) as well as manipulation contrary to s1041B.

Please call me on (07) 3867 4757 if you have any queries.

Shaun