INSIDER TRADING IN AUSTRALIA

PART 1

REGULATION AND LAW ENFORCEMENT

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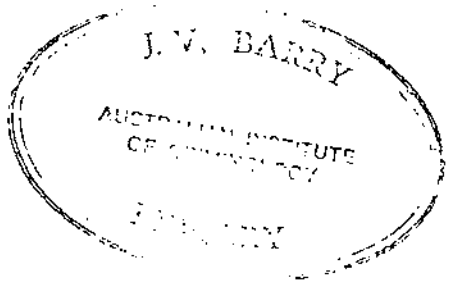
INSIDER TRADING IN AUSTRALIA - REGULATION AND LAW ENFORCEMENT



This is the first of three papers to be published on this topic by the Corporate Law Research Group within the Centre for Legal & Social Inquiry,
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1. Introduction

This paper is part of a wider study of insider trading in Australia which has sought to raise the level of debate on this often emotional and controversial subject. The study arose in the context of increasing concerns in this country regarding the incidence and implications of insider trading and its possible impact upon the market for securities and for law enforcement. Following the publication of the Anisman Report by the NCSC in 1986 there was a widespread reaction that more evidence about the nature and extent of insider trading as a problem in Australia was called for. Of course, the publicity surrounding the enforcement of insider trading laws in the United States, and to a lesser extent in Britain, led many to believe that insider trading may also be a problem that faced our securities markets in this country. With the support of the Criminology Research Council and of most members of the Ministerial Council on Companies and Securities we decided that it was timely to seek to inject some more concrete evidence into the Australian insider trading debate, particularly as there have not been any successful prosecutions of such conduct.

The lack of case law in the country on this topic meant that at least one of the traditional responses available to legal researchers was not available to us. Such case analysis that we did undertake was limited to overseas cases and to the few unsuccessful prosecutions which had been launched. This was not a very promising approach to take with a view to obtaining a better understanding of insider trading in Australia. The other traditional approach to legal research was to engage in that fairly abstract and sterile debate concerning the policy issues surrounding the enforcement of insider trading which has particularly characterized the North American law review literature. Whilst we of course surveyed this fairly arid jurisprudence, we did not feel that it would be productive to seek to add to it without some more tangible evidence. For these reasons we decided to adopt what for many lawyers must be seen as a fairly unusual approach, namely, we decided to undertake an empirical study of the attitudes and experiences of key players in the securities industry with a view to systematically collecting more reliable evidence than the largely impressionistic material that up until this time has served as the basis for policy debates regarding insider trading in Australia.

The study is based upon interviews with officials and professionals in four Australian cities. These were Canberra,

Melbourne, Perth and Sydney. We also obtained mail responses from officials in other capital cities. Our research was assisted greatly by the support which we received from the relevant Attorney's General and Commissioners for Corporate Affairs and their staff in each jurisdiction, as well as from the Australian Stock Exchange branches in each city that we visited. The NCSC also proved to be most helpful at different stages of this research. We were also able to obtain access to principals and staff in over twenty broking houses, as well as to at least a dozen partners undertaking corporate and takeover law work in the four largest law firms in each of the cities that we visited. The study also included merchant bankers, financial advisers, representatives of industry groups and financial journalists. Our interviews with each of these individuals often took up to two hours and sometimes even more. We were surprised by the willingness of these busy professionals to be so generous with their time and that of their colleagues. We often found that the person that we had arranged to interview also brought along one or two other colleagues to participate in the survey. This certainly served to enrich the study greatly, although it often had the effect of prolonging interviews quite considerably.

This paper is the first of three or four papers which will present the basic data drawn from this research project. Other papers nearing completion are concerned with the nature and extent of insider trading in Australia, business ethics and attitudes to insider trading and a more theoretical paper on insider trading as a phenomenon. These are based upon about 2000 pages of questionnaire responses which we received. The questionnaire contained 66 questions and was open ended in design to allow us to explore related issues as they arose during the course of the interview. We had a core group of 30 questions that all interviewees were asked to answer and the remaining questions were designed for particular industry groups, such as brokers, lawyers and enforcement officials. The questionnaire was pre-tested with interviews in Canberra late in 1987, with the main body of interviews taking place in Perth during the first week of February 1988 and in Melbourne and Sydney during two weeks in May 1988. A number of other interviews of regulatory officials in Canberra, Melbourne and Sydney took place during the first half of 1988. Library research of legal issues is certainly much to be preferred over this kind of fairly arduous field work. On the whole, we spoke to, or received responses from, a total of 99 persons and conducted a total of 79 interviews in Australia. One of us also interviewed enforcement and stock exchange officials as well as insider trading researchers in London, Toronto and

Washington to obtain comparative insights for the Australian study. To our knowledge, this is the largest study of its kind undertaken to-date. This research has also proved that empirical research can provide invaluable insights into the operation and meaning of corporate and securities law in Australia, adding a vital dimension which is simply not available from the limited body of case law in this broad area.

The problems of regulation and enforcement are of course central to an adequate understanding of insider trading in Australia. To a large degree it seems to be just as true in Australia as it is in the United States that there are major limits to the extent to which the law applies to the area of corporate behaviour. As Christopher D. Stone put it over a decade ago in regard to the US, this is an area "where the law ends." It would be true to say that, despite the existence of fairly strong language in section 128 of the Securities Industry Code, this body of law has not penetrated very deeply into the consciousness of securities industry actors in Australia, and it certainly has only had a limited impact upon them. The very fact that this law has remained largely unenforced has added to the general belief that for most practical purposes there is no law in force in regard to insider trading in Australia. We sought to explore why this seems to be the case and what might be done to remedy this situation. In forty three different questions we explored a variety of issues concerning the nature of regulatory problems and experiences, problems facing the enforcement of insider trading, the perceived effectiveness of different remedies for insider trading and the prospects for greater resort to self regulatory strategies in responding to insider trading conduct. There is an overwhelming view amongst the professionals working in the securities industry that insider trading is undesirable and should be prohibited in some way. Equally strong is the level of criticism of the CAC's for their failure to come to grips with this problem. There are however serious constraints which the regulatory institutions face and this is also widely recognized. Surprisingly, there was also a widespread view, especially amongst lawyers, that the current insider trading laws did not need to be significantly reformed, but rather that they needed to be more vigorously enforced. The purpose of this paper is to examine these concerns more closely and to seek to highlight the regulatory and enforcement dilemmas which have done so much to undermine the effectiveness of laws in this area in Australia.

Why prohibit insider trading?

Issues of regulation and enforcement of insider trading were at the heart of this study. We began by asking what the interviewees believed the policy justifications for the regulation of insider trading regulation to be (Q10). There has been considerable debate in USA about the policy basis for the prohibition of insider trading. In the literature, several views exist. These include arguments based upon market efficiency, the fiduciary principle and general notions of fairness.

The reasons given by brokers for having insider trading laws covered much the same range with some degrees of cynicism. Those who thought that the purpose of insider trading legislation was to protect the market typically said that it aims "to provide fairer markets by promoting equal treatment and to stop illegal gains. In short, to provide a level playing field" (B32). According to another broker, this would provide an equal chance for small and big investors (B54). A typical commentary on the effectiveness of the law in the market was that "the law seeks to establish a level playing field - but it is impossible to achieve perfection." (B37). A number of brokers saw section 128 as part of the general principle of investor protection. According to this view the section seeks "to protect the innocent man in the street" (B30) and "it is part of a general tightening of regulation and it has a social goal of protecting people" (B48). The laws are seen to have the goal of seeking "to protect small investors - the non professionals [and they] aim at the big insider trader" (B9). A variation of that view was that insider trading was dishonest and that the law exists "to control theft - an attempt to set some standards for an immoral community" (B43). Several others also described insider trading as a form of theft.

The fiduciary principle was only occasionally recognised. As one broker explained "the law is trying to eliminate the wrongful use of information for personal advantage. The practice of making personal profit before company gain must be regulated. People who talk about a free market are talking through their hats" (B50). An omnibus explanation for this was provided by a Sydney broker who thought that the law existed " because of a fear that somebody is being ripped off. For reasons of justice and well being; to provide a level playing field; and as a matter of motherhood" (B51). The more cynical brokers offered less lofty reasons. "It is a sop to the public to keep up public confidence" said one and this view was shared by another Sydney colleague

who suggested that "politically they had to so something - people expect it to be there" (B52).

Stock exchange officials offered several views of which fairness and the maintenance of a level playing field were the most common. One saw the level playing field in terms of "...providing a fully informed market leading to efficiency"(R12) while, for another, the level playing field meant seeking "to achieve a fair market" (R66). Not only did the legislation seek to provide a level playing field but it was seen to exist "to increase pressure for disclosure and it encourages a fairer market" (R21). Another of the officials explained that the law is there " to provide a fair and open market; to enable all players to have the same information and for reasons of market efficiency. Basically it is there as a matter of morality" (R18). Others said that the law aims to achieve "equally accessible information and fairness" (R71) as well as the "maintenance of an orderly market" (R26).

Similarly, most of the explanations offered by the financial advisers revolved around notions of equality of access to information, equity and market efficiency and some references were made to controlling specific behaviour. One statement was that "it is difficult to say. It stems from the rationale that there will never be a perfect market because there is an inequality of information. The aim is to ensure that those with information do not take advantage of those without information" (FA40). Another explanation was that the

> "fundamental reason is fairness. An efficient market requires equal access to information. The theory of fiduciary duty is not understood by brokers so we need a simple statute that is understood by potential insider traders" (FA60).

Talking of the control aspect, a fund manager reported that "the existence of the law modifies the behaviour of the market players. Insider trading is like prostitution - tolerated to an extent but still illegal" (FA63). A different explanation was offered by one of the merchant bankers who said "there isn't any reason. The law is a result of the State governments responses to the Rae report. The lack of financial and political support of the CAC's shows that insider trading is not important to governments" (FA41).

Many of the market observers offered a number of reasons but the notion of fairness was the most common and the level playing

field metaphor was also frequently mentioned. Perhaps the most representative explanation came from one of the group who was associated with, but not part of, the market and who explained that "with our system of limited liability companies it is unjust that some should have access to information while others do not. This is not right in a system of stock exchanges. It is also necessary to have a level playing field" (O59). Another summed up the need for insider trading laws as being "a matter of equity; to enhance confidence in the securities market and to limit the risks to which investors are exposed" (O53). Most of the views of those in this group followed the same line but one market observer said that "morally you must have insider trading laws". Another different approach was to say that regulation is necessary to "uphold the fiduciary principle and to act against fraud" (O25). The one discordant note was that "something is better than nothing" (O34). That person went on to say that "the UK model is a sound step". The responses in this area were very similar to those recorded by other participants in the study and it is interesting to note how infrequently the fiduciary principle was referred to.

When we asked this question of the lawyers the most general policy justification was frequently expressed in terms of "fairness" (L 56) or as another lawyer put it "for the market to be efficient it has got to be fair. If blatant unfairness like this were permitted, the market may not be competitive and efficient" (L36). This view was often elaborated upon by our respondents. For example, as a Sydney lawyer explained,

> "the main policy justification has to be to encourage efficient capital raising and to enforce moral attitudes in the community. Insider trading is bad and should be inhibited" (L61).

Similarly, a Perth lawyer observed "the policy behind regulation is to ensure that people don't profit unfairly, to provide investor protection and to provide a fully informed market" (L13).

The goal of providing an informed market was reiterated by other lawyers (eg L14), or expressed in terms of "investor protection" (L39). Others also adopted the sporting metaphor and saw insider trading regulation in terms of providing a level playing field, which was in turn based upon notions of the fiduciary obligations of trustees (eg L55). Thus one Sydney lawyer explained that "the conventional view is to provide equal access to information in the

market. Traditionally there has been an emphasis upon fiduciary duties" (L57). However, the fiduciary duties argument is not without its critics. As one Melbourne lawyer observed

> "the policy justification for regulation is based upon fiduciary obligations to shareholders. This is unrealistic today and reflects a paternalistic attitude" (L38).

This view was also put by a number of other respondents and may in part reflect the fact that this is very much a lawyers' doctrine which many non-lawyers find somewhat difficult to comprehend. We will return to this later. In the meantime, some interviewees pointed to the artificiality of these policy rationalizations. For example, one lawyer observed that : "section 128 is a dormant section. If it was policed and if there were a few prosecutions, people would take more notice of it" (L13). Another lawyer was even more critical when he noted that "there is no justification for the regulation which we now have. But if there were effective regulation the policy would be to provide a level playing field and equality of knowledge. Also, people just shouldn't cheat" (L15).

Regulators also saw the policy justifications for regulation in somewhat simplistic terms. The aim of insider trading regulation was seen to be the protection of the small investor (R4) and the creation of a fair market by seeking to keep investors fully informed (R3, R23, R70). The rhetoric of the level playing field was often also relied upon as a suitable metaphor to apply to this ethos of fairness, although one regulator thought that this metaphor was not very appropriate to insider trading. As another regulator fairly characteristically saw it

> "fairness and equality in the market place is the policy behind the regulation of insider trading. This is akin to ensuring that the horse race has not been fixed" (R67).

This was put in similar terms by another regulator when he observed that the aim of insider trading regulation was "to provide a market which is fully informed, allowing investors equal opportunity to participate in the benefits of securities traded on that market" (R70). This was put even more forcefully by another regulatory official who remarked that "insider trading involves using information acquired in a wrongful or improper manner to

gain a personal advantage to the detriment of others and as such it requires a criminal sanction" (R69).

On the whole then, there was a fairly uniform expression of hostility to insider trading and a shared belief that such conduct should be prevented. Although the policy justifications for this varied, most felt that insider trading was at least unfair and possibly even harmful. The policy of continuing to outlaw insider trading as a market practice is therefore almost universally accepted as an essential device for ensuring the integrity of the securities market.

Insider Trading and the Criminal Law

Any discussion of the enforcement of insider trading prohibitions must ask what the most appropriate legal means to achieve insider trading control are likely to be. We therefore sought to ascertain if the criminal law was seen as an appropriate mechanism for dealing with insider trading (Q12).

The lawyers were well placed to provide us with authoritative answers to this question. Most thought that there was a place for the use of both criminal and non-criminal remedies, although ultimately the threat of imprisonment was seen as a powerful and indispensable deterrent. A small group of lawyers thought that civil remedies whould be more appropriate. As one Melbourne lawyer put it "the criminal law is not really appropriate. It would be better if the emphasis of sanctions was upon compensation to recover illgotten gains plus some penalty" (L35). Another Melbourne lawyer took a similar position when he answered

> "I don't believe that insider trading ought to be a crime, except where the people deliberately get out of the stock before the market collapses" (L38).

A Sydney lawyer also took this general approach upon the basis that insider trading was akin to being a victimless crime, or as he put it "insider trading would be better dealt with as a civil matter for reasons of fairness. But you never know who the other party is" (L56). Most of the other lawyers however, thought that civil remedies should supplement the existing criminal penalties, although all recognized the problems of proof involved in resort to the criminal law. As one Sydney lawyer put the case for resort to the criminal law "the threat of gaol is an enormous threat, more

today than before due to the state of the prisons! But insider trading need not exclusively be dealt with by the criminal law. The use of licensing powers is also an effective remedy" (L57). A Melbourne lawyer also observed that "if the main purpose of the law is to act as a deterrent, then yes [the criminal law is appropriate]" (L39). Our Perth interviewees were particularly impressed by the suitability of the criminal law. One of these observed "What are the alternatives? For the law to have effect, it has to have a credible punishment." (L13). Another Perth lawyer went on to add "it comes down to making people sit up and take note. A criminal prosecution brings with it a stigma, etc. This is an important thing for management to avoid. Insider trading is a type of stealing and therefore has to be punished to redress the balance....." (L14). Perhaps the most vehement defence of the criminal sanction came from another Perth lawyer when he argued

> "the law would not be self policing if it were only a civil offence. But, if there were contingent fees, then it would be different. So, at present, insider trading laws have to be enforced at the cost of the State. Judges say that it is not up to shareholders to enforce the securities laws. There is no problem with the combination of civil and criminal liability, but there must be contingent fees if there is only to be civil liability as civil enforcement of securities laws is illusory at present, except in the odd case" (L15).

One solution to the problems of proof involved with insider trading laws was suggested by a Melbourne lawyer when he observed that "the big problem is for the court to infer that there was insider trading from extrinsic material. The courts should infer from commercial reality even though these are criminal offences" (L36). A somewhat more reflective view was offered by a Sydney lawyer when he argued "we have got to make up our mind if prison is appropriate or whether we should introduce more realistic fines. People don't take seriously monetary penalties of the type we presently have. But, they do take prison seriously. Also, they do take multiple fines seriously. However, I don't believe that just because some people get away with it, that section128 is a waste of time" (L61).

Most regulators had no doubt that the criminal law was an appropriate mechanism for dealing with insider trading, although

a few also had mixed reactions. A small group did however have serious doubts concerning the appropriateness of criminal sanctions, for as one of these told us "a negotiated settlement, with associated publicity may be more appropriate." He went on the observe that the "attitude of the judges makes the criminal process inappropriate. It is difficult to align an otherwise respectable businessman with criminals" (R20). These practical problems of prosecution seemed to be the main reasons for the criminal law being seen as inappropriate, for as another regulator simply put it "magistrates just won't send prominant businessmen to jail" (R67). There was some agreement that insider trading should not be classed in the same way as other criminal offences. As one regulator explained "our criminal justice system is not appropriate for these market related crimes. A better system would be to use injunctions to 'undo' the transactions. In some ways this conduct is quasi-criminal." (R19). However, most other regulators saw the criminal law as playing an essential role in this area. As one regulator explained "the fear of imprisonment is the only detriment insider traders will understand" (R3). Most others simply agreed that the criminal law was appropriate, however it seems that there is wide support for the existence of a combination of criminal and civil penalties for insider trading. As one regulator put this point "the criminal prosecution has to be part of the process, but there should be a package of criminal and civil actions" (R22).

The universal view amongst brokers was that criminal sanctions were appropriate for dealing with insider trading and the only qualifications to this view were suggestions that there be some discretion according to the scale of conduct. One group of brokers felt that the criminal law was the only mechansim which could realistically be applied. As one Melbourne broker put it "there is no other way to achieve a form of compensating the community" (B28). In this group was a Sydney broker who told us that "the laws are not effective but what is the alternative? The sleazy end of the market has to be controlled somehow" (B51). The value of the criminal law was explained in different terms by two brokers. One observed that "insider trading goes beyond civil law and therefore it is appropriate to use the criminal law" (B44) whilst the other noted "what else is there as the proper means of punishment for a breach of fiduciary duty?" (B54). He went on to say that "to lose one's licence is a harsh penalty" and perhaps he meant that the criminal law sanctions are not as harsh. One broker could not think of anything better (B29) while another asked "why not?" Other brokers expressed different views. One Sydney broker remarked "it frightens the white collar operator.

The prospect of gaol is the ultimate deterrent". In contrast a Perth broker told us that he did "not like criminal law - insider trading is a victimless crime - but the criminal law is necessary" (B10).

Those who qualified their support for the use of criminal sanctions referred to the circumstances surrounding the conduct. In the words of a Sydney broker "I suppose so. It is a question of degree - for Boesky style insider trading, yes, but for more innocent instances, no. I am in favour of criminal law provided there is some discretion" (B48). To the same effect was the comment of Melbourne broker who felt that the criminal law was appropriate in certain cases, especially "for large operators" (B43). A Perth broker expressed some ambivalence when he answered "personally no, but I guess it depends on the circumstances" (B8).

One response from stock exchange officials on this issue was "possibly" (R71) and another said somewhat curiously "I am an accountant, I don't know" (R21a). The remaining ASX officials were in favour of the current approach. An interesting answer was that insider trading should be criminalized "because of the lack of class actions. It is a criminal act - there is a social responsibility to prosecute" (R12). This comment might be seen as a poor reflection on the value of section 130 of the securities Industry Code, which provides for compensation for the "victim" of insider trading, and taking it further, it also reflects badly upon the practical exclusion of small investors from the remedies offered in the Companies Act.

When we pursued this issue with the financial advisers, we found that there was some division of opinion. Those who agreed without any qualification that the criminal law is appropriate said that "there are no other options" (FA11) or that "insider trading is fraud" (FA42). The qualified affirmative answers included these: "as a deterrent yes [it is effective], but as a mechanism, no." (FA17); "the criminal law is appropriate where inside information is withheld in order to perpetrate a fraud as in the 1969/70 mining boom but not otherwise" (FA41); "yes, if there is also a civil remedy such as disgorgement of profits" (FA60). Of those who did not agree that the criminal law was suited to this area, one said that "a financial penalty is preferred" (FA62) and another that "white collar criminals do not go to gaol" (FA63). These views seemed to reflect a realistic grasp of the limitations of the criminal law.

The market observers' answers fell into three categories. Of those who agreed, some did not elaborate. The strongest view was that "it is hard for any civil remedy to be used by shareholders and therefore the criminal law is appropriate - the authorities are best able to prosecute" (O64). The "no" group offered a variety of reasons. A former broker told us that he "had never been terribly impressed by the criminal law - the agencies do not know where to look. The police should be kept out of it" (O65). Another said that the criminal law was of doubtful value and that "it is better to divest" (O34). Another made the comment that "I would prefer to see it as a civil matter and I particularly like the section 16 approach used in USA" (O25). Those who were ambivalent also had different reasons. As one explained "at times the criminal law is appropriate. There are different classes of insider trading - deliberate or calculated (Boesky style) and deliberate without full knowledge of what is being done. These should be treated differently" (O59). Another's view was that "by itself the criminal law is inadequate. A full armoury is needed" (O53).

Despite some reservations about the problems of actually seeking to apply the criminal law against insider traders, we were left in no doubt that for one reason or another it was essential that the criminal sanction continues to be available in this area. This view was enhanced by the strong criticism of the illusory nature of civil remedies as a sole means of response. Whilst fines were generally seen as being of little significance, imprisonment was seen as a real deterrent. However, in view of the practical difficulties involved in resorting to criminal sanctions there was a genuine basis for ambivalence about their effectiveness as a sole device. Most agreed that the criminal sanction had to be coupled with stronger civil remedies. There is also a good case for greater resort to negotiated settlements and quasi-criminal sanctions either to get actors to leave the industry or to undo transactions. So long as the problems of proof continue to present such considerable obstacles, these alternatives need to be looked at more seriously.

The adequacy of current penalties

We next turned to ask whether the current criminal penalties of $20,000 and/or five years imprisonment were seen to be appropriate for insider trading (Q 13). One of the real difficulties

in answering this question was that there have not been any convictions for insider trading in Australia.

Most lawyers, for example, thought that five years gaol was clearly credible as a deterrent, provided there were prosecutions. As one Melbourne lawyer put it "Yes, if there were prosecutions the effect would be devastating upon the offender" (L36). Another Melbourne lawyer made the same point when, after agreeing, he observed "but the fact that prosecutions are not launched has made the criminal penalties less of a deterrent" (L35). This seems to be particularly so at the "top end" of the market, for as another Melbourne lawyer noted "the current penalties are not a deterrent for the big players" (L39). Realistically, however, gaol is hardly a deterrent due to the fact that it is not applied. A Sydney lawyer therefore answered that these penalties were not credible "as the law is not enforced or enforceable. Penalties are not thought about as everyone knows that no one is ever sent to gaol" (L56). Another Sydney lawyer added that "these would be better deterrents if someone were convicted. It would then be brought home to people that imprisonment was possible" (L61). Interestingly, almost all lawyers were of the view that the $20,000 fine was far to low. As one Perth lawyer put it "$20,000 of itself is not a big deterrent. There is a mismatch between the $20,000 fine and five years gaol" (L14). Many thought that the fine should be a lot higher. However, if there is not to be much enforcement, one Melbourne lawyer realistically observed that "if you increased the penalties to $100,000 and/or seven years gaol it would not make a difference" (L55).

A few regulators were however of the view that the existing penalties for insider trading were sufficient. As one of these put it "the penalties are adequate, the difficulty is in proving the offence" (R1a). The other regulator who agreed that present penalties were adequate added that "the penalties would be a more effective deterrent if the offence was one subject to extradition proceedings" (R69). Some others were prepared to say that a gaol sentence of five years "may be a deterrent" especially, as another regulator noted, "if the courts would only impose it" (R22, R24). The problem with these penalties was seen to be that as "these are maximum penalties only, judges won't impose the gaol sentence and the fines mean nothing to insider traders" (R1). Indeed, one regulator thought that there should be "minimum gaol term of five years", if gaol was to be seen as an effective deterrent. He was not alone in calling for increases in the penalties for insider trading. However, as this experienced

regulator went on to tell us "since it is difficult to find a victim the courts regard insider trading as a technical offence and so won't impose the maximum penalty" (R3). The current fine of $20,000 was seen as being quite inadequate by most regulators. As one aptly described it "$20,000 is a parking fee" (R67). This fine was not seen as an effective deterrent at present. As another regulator observed "corporate offenders do not go to gaol. Insider traders will not be deterred by a $20,000 fine. This is seen as being just a risk to be balanced against the gains" (R2). Put a little more colourfully "the $20,000 fine is a joke; gaol is what corporate criminals fear: (R19). Some regulators also saw value in a combination of measures in addition to fines and gaol, such as the introduction of the power to name insider traders, for as one regulator explained, "adverse publicity is an effective deterrent" (R23). **However, if the regulators are to be believed, and there seems to be no reason not to do so, we now have the worst of possible situations in respect to penalties for insider trading. Not only are the courts most unlikely to impose prison sentences on insider traders, in the unlikely event of fines ever being imposed, these are seen as constituting trivial imposts upon the insider traders. On the whole, it seems that our whole approach to penalties seems to be somewhat unrealistic and has served to further undermine the effectiveness of the regulatory institutions. At the very least, it has undermined the confidence of these institutions in the value of our insider trading laws.**

The majority of brokers felt that the current fine was too low to be credible but the sanction of imprisonment was seen as being credible. However, it might well be the case that a conviction is the most feared punishment. On the subject of the fine, brokers said "it is not credible for the big ones" (B37) and "it depends on the person. For the small person it is; but for the major person it is not" (B43). The present fine was described as "...ludicrous, it is no threat" (B54); another broker described it as being "hopeless" (B47). Another felt that the fine should be "huge - more than just what was stolen. It should be one and a half times the gain" (B30); others felt that the fine should be "heavier" (B8); or "related to the damage" (B52); and "could be higher , say $100,000." (B58). As to the term of imprisonment, the views of brokers were mixed. For example, we were told that "the threat of gaol is adequate" (B29); "the threat of gaol is terrifying - the length of sentence is irrelevant" (B50); "gaol especially [is feared]. Money is not a deterrent" (B44).

But, whatever the fine or the possibility of imprisonment might be, the common view was that "once convicted you are finished" (B50) as "gaol is very much a deterrent - you lose your licence and job" (B54). The same fear of the consequences of conviction appeared from several other answers - "gaol, yes - it is the ultimate punishment - there is a loss of money, humiliation and loss of career" (52); or "the real deterrent is what the market will do to you" (B28). A more practical approach to the consequences of imprisonment was that "the real punishment is that a long term in prison destroys your contacts and you have to start all over again" (B51). Among those who took this view, their attitudes could be summarised in the words of another broker who said that "the threat of career damage is the deterrent" (B72).

There were, however, some qualifications about the deterrent value of the penalties. One broker observed "if there was a successful case, a gaol penalty would be very effective" (B8). As another broker explained, "on face value they are deterrents but they are not enforced or publicised. They are not credible with a lawyer being able to get people off" (B27). Other brokers, felt that the current penalties would be credible deterrents only "if a judge would ever give the maximum" (B58); or that "..gaol is credible, but would the maximum be imposed?" (B9)

Other broker views were that these penalties are credible enough - it depends on the scope of the operation. The level does not matter - "the removal of profit is the most effective ...." (B29). Similarly, another observed that "gaol should not be there - it does not do anything. There should be equality of punishment" (B30). An important point was made by a Sydney broker when he told us that "it depends - for those in the industry - yes [the penalties are a credible deterrent]. For those outside the industry they probably are not" (B48). Perhaps the view that best reflects the feelings held by brokers on this subject was that these penalties are not credible as

> "they would only get the little person. On sophisticated insider trading deals they feel they would not be caught. The biggest fear and deterrent is the loss of reputation" (B32).

In contrast, the opinions of the exchange officials were somewhat difficult to establish. Those who addressed the question thought that imprisonment was a credible deterrent but that the fine was far too low. Others wondered whether the lack of prosecutions affected the impact of the penalties. What did emerge from the

question was that only one official regarded the penalties as credible and adequate.

Most financial advisers thought that the penalty of imprisonment was credible and adequate but that the fine was not. There were, however, some qualifications in the views expressed. One of the investment advisers suggested that "if prison was mandatory that would be a sufficient deterrent" (FA75). The lack of convictions was also commented upon. As one explained, "[it is not credible] especially since there has been no conviction" (FA6); or, as another adviser put it "they are not adequate but does it matter if no one is being caught?" (FA33). A different approach was taken by one of the merchant bankers who said the penalties are

> "entirely adequate but the real deterrent is the loss of a career. Penalties are not the point - it is lack of enforcement" (FA41).

There was very little said in favour of the current level of the fine. As a funds manager put it " a $20,000 fine is comic, the best punishment is loss of livelihood, suspension of licence and adverse publicity" (FA63). Merchant bankers also had things to say about the penalty system. For example, we were told that "corporate criminals are never sent to prison, the fine should be half a million dollars" (FA62); and that

> "the gaol sentence is excessive but a $20,000 fine is a joke. The fine should be related to the gain. Judges do not understand market reality and morality and will usually get the sentence wrong" (FA60).

The reaction was generally the same from each of the market observers but a sizeable number of them said that the lack of prosecutions and enforcement was a limiting factor in deterring insider trading. As one said of the deterrent value of the penalties "if they hit they do [deter]. A big hit on somebody would make a big impression" (O65). Another view was that "sanctions per se are not a deterrent - it depends on enforcement. The levels should not be raised" (O75). There seemed to be a widespread agreement to the effect that the fine is too low but that the prison sentence is appropriate. On the subject of fines the comments included observations such as the following "the fine is a joke - it should be equal to the profit" (O34); "the potential rewards of insider trading are very high - in the hundreds of thousands of dollars - and the fine is too low. It should be $100,000" (O64);

"the level of the fine is not realistic - even $100,000 would be pretty low" (O59). Another suggestion on the size of the fine was that it should be increased to $5 million (O7). A different approach to the whole issue was that the penalties are not of any deterrent value "because of the inadequacy of the legislation. The size of the penalty is not determinative. Access should be improved through the availability of class actions" (O53).

It was interesting to note the answers to our question about the significance to brokers particularly of a prison sentence (Q48). As we saw, the brokers had told us that the real punishment is not being sent to prison or being fined but career destruction and the officials said precisely the same thing - "conviction is the end of your career, you can no longer get access to confidential data" (R18). The responses to these questions suggest that there is scope for a more innovative approach to setting penalties with an emphasis on increasing their deterrent value but perhaps the most effective deterrent, for brokers at least, would be a credible enforcement effort.

The Fear of Imprisonment

Imprisonment is clearly feared by brokers, but the knowledge that it is not used does undermine its deterrent value. The mildest response was that it was "a significant punishment" (B8). Other terms used to describe the effects of imprisonment included "stigma", "shame", "disastorous", "the ultimate punishment" and "terrible". Some brokers were particularly frightened at the prospect of being in a prison but the more common references were to the consequences of imprisonment - the loss of licence and the destruction of a career. This view was shared by all licenced professionals that we spoke to. There was a strong suggestion that merely to be convicted would achieve the same result. There seems to be an ambivalent attitude to being known as a insider trader but it is different and much more serious to have been convicted. The financial advisers all said that imprisonment would be serious mainly because of the stigma involved. Surprisingly only one referred to the consequential career destruction as an even worse punishment (FA33).

The current criminal penalties of five years imprisonment and/or a fine of $20,000 are clearly not perceived as credible deterrents for inside trading. The main reason for this is the lack of enforcement of section 128. Were this law to be enforced it is clear that the

fear of imprisonment would constitute a serious deterrent, although it may be desirable to think about introducing a statutory minimum period of imprisonment. The fine of $20,000 is however a different matter. This was all too frequently described as a joke or at least quite unrealistic in terms of the likely gains to be made, especially by the big players. There seems to be a compelling case for an increase of fines up to at least $100,000 for each offence. Such an increase is in line with international developments. However, even this higher fine would be irrelevant if it were not to be applied. It is clear that money reputation and freedom of movement are highly regarded values in the securities industry. If insider trading penalties are to be seen as serious, then they must impact upon these values. To date this has not occurred and is all too widely perceived as not having occurred.

Civil Penalties

We went on to investigate whether civil penalties, such as treble damages and the disgorgement of profits would constitute a more credible deterrent than the use of criminal sanctions (Q 16). Civil penalties were generally not seen as being a viable replacement for criminal penalties, but rather as a supplement to them However, a not uncharacteristic view was that "we already have enough penalties, but we don't have enough enforcement. Huge penalties are not worth it unless someone is doing something about" (L15). There was however some uneasiness about the introduction of treble damages amongst some interviewees for an assortment of reasons. For example, a Melbourne lawyer who consistently opposed the ban on insider trading, said "I don't like treble damages as you create a windfall gain for the person damaged and it leads to vexatious litigation" (L39). Similarly, a Perth lawyer argued that "treble damages are not suitable to Australia, it has administrative problems and has to be enforced" (L13). Apart from these, most other lawyers thought these civil remedies would be quite effective. Disgorgement of profits was seen as being particularly effective for, as one lawyer observed, it is "the profit motive [which] leads people into the mire" (L39). Similarly, a Perth lawyer thought that "the disgorgement of profits should be provided for in the legislation" (L13). This was confirmed by a Sydney lawyer who thought that "the disgorgement of profits was a useful way to proceed" (L61). However, in the end, most lawyers thought that civil remedies

were only a supplement to criminal remedies and not a replacement for them.

Most regulators were, as we saw, somewhat disheartened by the use which had been made of the criminal law in this area. It was not surprising therefore that they went on to generally agree that the use of civil penalties such as treble damages and the disgorgement of profits would be more effective deterrents than the deterrent value which the current criminal law is seen to have. However, most felt that the use of the criminal law would still be needed, even if greater use was made of civil sanctions. There were, however, a few regulators who were sceptical about the use of these civil remedies. As one explained "disgorgement won't hurt them. The true inside trader does this over and over again; gaol is the only deterrent" (R3). Another regulator took a similar view when he also opposed the greater use of civil penalties, remarking that "the practice would then become subject to cost benefit analysis by the perpetrators. The only real deterrent [namely] the potential shame of being criminally convicted, be it very remote, would be removed" (R69). Most regulators felt that it was necessary "to hit their hip pocket" (R4). Similarly, we were also told by a number of interviewees that "short swing profits should be returned to the company; disgorgement is good as it adds pain" (R67). However, few regulators saw civil penalties as a viable replacement of the criminal sanction. As one regulator characteristically put it

> "I have no objection in principle to civil penalties if the purpose is to protect the small investor and if civil remedies can be achieved despite the lack of convictions. However, the government should not exact civil penalties, it is better to lock people up. Any way of buying one's way out of guilt is wrong" (R23).

Ultimately, however, the real issue is the detection and prosecution of insider traders. Unless this occurs and unless there are convictions, the introduction of civil remedies was seen as being of little value as an alternative (R1). Nevertheless, there was some attractiveness to the regulators of the idea of introducing civil remedies to supplement existing sanctions. As one regulator observed "the U.S. experience shows that a negotiated civil settlement has some advantages; it is quickly done and allows a flexible approach plus publicity" (R20).

The brokers were generally in favour of profit disgorgement but were not as enthusiastic about treble damages. According to a Melbourne broker "the basic starting point is to be forced to shed profits" (B32). Another went further to say that "the penalty needs to be profit, plus...." (B52). He had support from another Sydney broker who said that "disgorgement is sensible and necessary." A Perth broker put it this way - "both are needed and also a compensation mechanism" (B9). One Melbourne broker felt that "the gain should be removed" but he was "not sure about the damages going to the government" (B31). This theme was taken up by another broker who said "it is a much fairer system. But where does the profit go - the other party was going to sell anyway. Double profit would be okay and it could be used to fund NCSC surveillance. The NCSC keeps on losing; moral suasion would be more useful" (B54). Cautionary comments came from a Melbourne broker who pointed out that "the penalty should be more than the profit but 90% of insider trading is done at a loss" (B30). Similarly, it was colourfully explained to us that

> "disgorgement makes better sense but how do you compensate the victim? If there were treble damages who could pay? The usual insider trader is a slimebag who will ensure that he is properly organised and will not be able to pay. The person you catch will not be the one you want" (B51).

However the most pessimistic reaction came from a Melbourne broker who said "an increase in penalties of this order would kill market research" (B29). This fear seems to be an over-reaction. The view which seems to sum up the position of brokers was that "a combination of civil and criminal penalties would be terrific. The right sort of civil penalty would be appropriate" (B47). And, as a Perth broker remarked "it would be better than the present arrangement" (B8).

There was a general feeling amongst Stock Exchange Officials that there should be some pain associated with the penalty and in this respect the idea of treble damages attracted only one dissent - "treble damages would certainly be a deterrent, an extraordinary penalty which would probably bankrupt the person. It would be better as one and a half or double" (R66). Another thought that the pain should be applied by way of criminal penalties (R71). There was no opposition to the idea of profit disgorgement but concern was expressed in regard to where the money went. One official suggested that it should go to the loser. Another, who

opposed the idea of it going to the government, suggested that it go into a fund for the benefit of the persons who were the victims of the insider trading (R18).

The general view among the financial adviser group seemed to favour the use of both treble damages and disgorgement, although disgorgement had more support. This group reflected the views of others in this study who argued that there must be some pain associated with the penalty. On the subject of disgorgement there were several points made by members of this group, such as that "[it] would be an effective deterrent but it is necessary to define who should be compensated. Gaol should be mandatory: (FA74); "we need both civil and criminal penalties and any profits that are disgorged should be used to fund the NCSC" (FA42). Some difficulties were identified with disgorgement - "it is often difficult to identify any party who has been hurt. Disgorgement of profit really amounts to a fine" (FA40); while one of the merchant bankers confirmed the widespread opinion that "section 130 is a joke. It is unlikely that the hurt party can be identified. Any person who has suffered damage would find the legal cost prohibitive" (FA41). There was not a great deal of comment about the idea of treble damages but one merchant banker felt that "disgorgement of profits is not enough, multiple damages are needed to provide some pain" (FA62). A similar view was expressed by a funds manager who said that "treble damages are more realistic, there is no pain in disgorgement" (FA63). But there was some fear of the consequences of introducing treble damages. As one financial adviser explained "treble damages plus compensation could lead to class actions which are not appropriate in this area" (FA33). This is a questionable view, as class actions may be the only way of making section.130 more effective than it now is.

A general statement on the penalty regime was provided by another of the merchant bankers who felt that

> "there is a lot to be said for disgorgement and multiple damages. In the U.S.A. the law has resulted in persons knowing their obligations and in some discipline and introspection. The disgorged profits and the damages should go to the company and thereby to the shareholders. Class actions and derivative suits are appropriate" (FA60).

Another of the observers rejected the idea of civil penalties saying that criminal sanctions were needed (O75). The notion of disgorgement was acceptable to the others but one made the point that it is painless (O64). There was as we have seen some unfavourable comment about disgorging the profit into the hands of the government. One view was that it should go to the company (O59) while another (O34) said "it should not go to the government and there should not be punitive damages". There was not overwhelming support for treble damages - some said that double damages would be enough, while others did not explain their opposition. One unusual suggestion was that "the NCSC should consider using its vesting power" (O25).

Whilst greater use of civil remedies such as the disgorgement of profits and the use of multiple damages received widespread support, most felt strongly that civil remedies of this type should only supplement the criminal sanction and not replace it. Disgorgement of profits was especially approved of although most felt that there should be some pain in addition to disgorgement for disgorgement to be a deterrent. This applies especially to multiple offenders who may be detected on only one or a few of these occasions. Whilst there were frequent reservations about the introduction of treble damages, double damages had more appeal. It is clear that there is also a very strong case for the introduction in Australia of a version of the short-swing profits rule for all trades made by person connected with a corporation within , for example, six months of an announcement affecting that company. These should be returned to the company. It was also widely argued that disgorged profits from insider trading should not go into general revenue. One sensible suggestion is that these be used to support insider trading regulation and enforcement.

A Criminological Debate?

One of the concerns of this study was to make a contribution to the level of informed debate concerning insider trading in Australia. We were therefore naturally curious about the kind of debates that were currently taking place in relation to this issue at present (Q37). As we will see, there seems to be very little debate or discussion amongst professionals in different fields about insider trading at the moment. Whilst it

may be too strong to say that insider trading is seen as a taboo topic, there has not been much enthusiasm about public discussions on this subject. Even in organizations having a professional concern with this area, the level of debate has been disappointing.

For example, we asked the regulators how much discussion has taken place amongst regulators regarding the relative merits of different types of penalties (Q37). Most reported that there had been "none" or "not much" debate on this topic (R1a, R1, R2, R3, R4, R20, R67, R68). However, there is obviously some limited debate that is occurring, although this is taking place in a sporadic and limited way. Thus we were told that "there was a consistent debate until the Anisman report, which slowed things down. Also, the emerging Commonwealth control of the corporate area has frozen the debate" (R19). Another senior regulatory official reported that

> "there is a continuing debate concerning whether civil penalties were better than criminal penalties; civil penalties are quicker but criminal penalties have more deterrent effect. Most CAC's follow the criminal route but the NCSC prefers the civil route for reasons of speed. The debate also arises regarding the extent to which you can use administrative penalty systems, for example, for purposes of revenue raising" (R22).

This is probably a view that is more characteristic of national regulatory officials, for as one CAC-based regulator observed "there is a reasonable amount of debate with regard to penalties, but regulators are more interested in enforcement" (R24). The subject of penalties is apparently discussed in a general manner, for example, to see if these need to be reviewed from time to time (R68, R69, R70), but this is not solely directed to insider trading as such. **There is clearly a need to significantly improve both the extent and the level of criminological debate on questions of investigation, detection and enforcement of insider trading in Australia, although there are some signs that this is slowly beginning to occur. There is clearly much room for further improvement here.**

The enforcement of the current law

A feature of the insider trading debate in Australia has been the frequent reference to the paucity of cases and the lack of convictions for insider trading. This could be explained by several factors, among them - a very low level of insider trading, inadequate enforcement and inadequate deterrence. All of these were mentioned in responses (Q15). The overwhelming attitude, particularly of the large law firm lawyers, was that insider trading laws were not adequately enforced, although some thought that these laws were enforced as well as they could be. As one Perth lawyer put it "the laws are adequately enforced and one can't do any better. The difficulties of detection and identification are great and there is no help from the courts" (L14). A Sydney lawyer simply responded that "there are not the surveillance systems that are needed" (L57). However, others took a much more negative approach. This was most forcefully put by one Perth lawyer, whose comment is worth quoting in full. As he put it:

> "The laws in this area are a joke. You have to establish a credible enforcement record before people believe that there is anything to fear. It is only honest people who worry about the law. Section 128 is only a constraint upon the honest. The CAC will sometimes have a go to enforce the law, but they usually bugger it up. There is a basic belief in the industry that there are no rules, because there is no enforcement. The NCSC and CAC can't do it and shareholders can't afford to litigate. There are virtually no cases on section 128 and no attempt is made to recover damages. It is almost impossible to win a case. The prosecution has to be kept simple to succeed" (L15).

This comment reflects many of the other types of responses that we also received. It is clear that this disenchantment with the regulatory record is not limited to this one lawyer, as it is fairly representative. For example, one Melbourne lawyer elaborated upon this theme in the following way "the laws are not adequately enforced. It is difficult to know what problems the CAC's have had. I suspect that the problem has been a lack of energy and funds and not due to any defects in the legislation." He did however go on to add "I am not disappointed that there has not

been more enforcement of section 128" (L35). Another Melbourne lawyer did not, however, seem disturbed by the obvious lack of enforcement for the curious reason that "none of the companies legislation is enforced and shareholders don't worry about it" (L38).

This complacency was not characteristic of other respondents. There seemed to be more concern about the need for greater enforcement amongst our Sydney interviewees, although too much should not be made of this. Thus, one Sydney lawyer remarked that

> "there is room for a lot more enforcement. Regulatory monitoring systems are not adequate to pick insider trading up. The NCSC doesn't have the will to pick it up, although it would love to get a high profile insider trader. The problem with the NCSC is that they have a "goodie-baddie" mentality, especially in regard to professionals. It is often just plain wrong" (L56).

Another Sydney lawyer was equally critical of the regulatory agencies when he observed from the comfort of his well resourced high technology office:

> "I have never been satisfied that the insider trading laws have been sufficiently enforced. It is seen as being too hard. Most people are not aware of this. I don't know why insider trading is never pursued. I don't believe it is as difficult as it is said. The lack of knowledge upon the part of judges about commercial matters does not matter as judges know a lot more than they are prepared to let on. The CAC and DPP have tended not to worry about section 128 prosecutions. I would be more satisfied if they ran a few more cases" (L61).

A related problem is that whilst the surveillance of the market tends to take place at the NCSC, it is the CAC's which are required to act. As one Perth lawyer put it "this is a bit remote from Perth" (L13). Surprisingly, however, there was general satisfaction amongst lawyers with the legislation itself, which was rarely seen as being in need of major reform. The key problem was seen to

lie with the enforcement of this legislation. However, it may well be that the present legislation may set too many barriers for the regulators to cross, especially in view of the difficulties of getting people to come forward to provide evidence to facilitate prosecutions. We will return to this issue later.

In contrast to the lawyers, a majority of regulators thought that the insider trading laws were actually adequately enforced. As this question was particularly damaging to them if answered in the negative, their response is hardly surprising. However, most seemed to qualify their answers in some way. Only two regulators were prepared to provide an unqualified negative answer to this question. As one of these put it "no, because it is difficult to prove the elements of the offence, especially the price sensitivity of inside information" (R1). Most told us that whenever insider trading was brought to the attention of the CAC, it was dealt with by them (eg R2). A common feature of regulatory responses was a fairly defensive tone or reaction to the underlying thrust of our question. One regulator charactristically observed that "on the basis of the complaints and allegations received by CAC's the law has been adequately enforced; the problem is in identifying the instances of insider trading" (R19). Another regulator went on to expand upon this theme when he observed:

> "in terms of the number of prosecutions and convictions, no, the law is not enforced adequately, but the CAC's are anxious to enforce the law. The problem stems from the reactive nature of CAC's investigations; all complaints are acted upon. In order to detect and prosecute successfully, the CAC's require computer technology which will enable them to sift through the trading and identify possible insider trading" (R20).

Similarly, another observed that "an effort is being made, but the CAC's are hampered by the lack of appropriate technology and the lack of political support" (R22). This lack of resources was constantly alluded to by the regulators, as was their feeling that insider trading prosecution was not given much priority by their political masters (e.g. R67). One regulator thought that the laws were not adequately enforced "but in view of the lack of resources, the lack of technology and the lack of complaints, the best job possible in the circumstances is being done" (R24).

On the other hand, only one broker said unequivocally that the law was adequately enforced - "the NCSC is very quick to act. Brokers will quickly sort out a person who is out of step. Brokers are trenchantly and sometimes unfairly policed by the CAC and the stock exchange" (B44). The majority did not think that enforcement was adequate and they offered a variety of reasons for this, most of which were not particularly critical of the regulators. One of this group went on to add "but it is very difficult to say how it can be improved" (B32). Another asked "how can it be enforced? It is a bad law" (B43); but this was contradicted by a Perth broker whose view was that "the law is adequate but the enforcement is dubious" (B10).

Another broker suggested that "they need an effective monitoring system. The most likely way of being convicted is by bragging about it" (B50). A sympathetic explanation came from a Sydney broker who said that "the agencies, especially the NCSC try. They suffer from lack of financial resources and qualified staff. There are salary problems in attracting staff from the industry". He suggested that "perhaps they could recruit retired brokers" (B47). Another understanding broker said that "the CAC has a tough job and personally I think they do a good job but they cannot do the job - they need better laws. The NCSC does a pretty good job but the reactive style of operation is a problem" (B8). But not all the brokers were sympathetic. One of the Sydney brokers offered this commentary on insider trading laws when he asked "have they ever been enforced? Who has been nailed? Rumour is that the NCSC will strike for the sake of it. The law catches the wrong person - the minor insider" (B51). A similarly critical comment was made by another of the Sydney brokers:

> "they are enforced to the best of the NCSC's ability but they suffer from a shortage of funds and they concentrate on takeovers. The NCSC staff lack skill and market experience. The laws are badly drafted. There is no public confidence in the ability of the NCSC to detect and prosecute the big boys. They are seen as somewhat vindictive" (B54).

Several brokers were not very definite in their response. One Sydney broker said that "if they are there one presumes that the agencies are trying to enforce the law. Maybe the law is too hard to prove. They are trying without luck to enforce the law. That is not a great deterrent" (B49). That same degree of doubt was reflected in the answer of a Melbourne broker who said "I

suppose they are. It is difficult to prove" (B 29). A Melbourne colleague also displayed some doubt when he remarked "perhaps they are. The evidence is not there and maybe there is a low incidence of insider trading" (B28). One broker whose answers had indicated considerable reservations about the value of regulation in this area responded by asking "are any laws [enforced]? It is done far more stringently now - but how effectively? Perhaps there is a lot of insider trading that is not known about" (B31). There were some brokers who reported that they had no opinion on this matter and we could not establish whether they did not know or were too shy to reveal their perceptions of the adequacy of enforcement.

Apart from responses of "yes" and a "do not know" there were no direct answers from the stock exchange officials. Typical of the responses from them were that "the laws are respected and regulators have not ignored the law" (R12) and "they need test cases even if they lose. Maybe even by going to a higher court" (R21). One of the ASX officials provided this insight into the way in which the agencies work together "there is a long way to go from the investigation stage. The regulators would love a case but they do not want to work on it - they want the stock exchange to present a final case to them" (R66). Another of the officials clarified the position for us by saying "I cannot say. I do not know about the level of activity. The NCSC reacts to the information from the stock exchange by contacting the brokers" (R18).

The experience of the financial advisers suggests a perception that the laws are not being adequately enforced. Those who take this view did not, however express any criticism of the agencies. They attributed the inadequate enforcement to such things as "a lack of any monitoring system" (FA17); "a shortage of resources in the NCSC and CAC's" (FA33); and to the fact that "insider trading is not adequately supervised because they probably believe that they will never get a prosecution. The civil remedy is useless" (FA60). Those who said that the law was adequately enforced told us that "the NCSC is doing a good job considering the level of resources available" (FA11) and that the "monitoring system seems to achieve the desired result" (FA16). How can it be more vigorously enforced asked one (FA6) while another wondered whether "if the law is not enforced is there a law?" (FA40).

There was an overwhelmingly negative response from the market observers. Not one of them was prepared to say that the law was adequately enforced. The nearest they came to saying that it was, was to say that is is "probably not". The strength of these

responses reflects poorly on the perception of the agencies but it should not however be interpreted as a wholesale attack on the agencies as many also offered explanations as to why the enforcement effort seems to have missed the mark. One view was that the inadequate enforcement arose

> "not from a lack of will but due to a lack of resources. It is hard to deal with insider trading other than through the criminal system but it takes years to get to court and there are risks of witnesses being no longer available. They should be given resources matching the revenue they generate. The NCSC's informal approach of encouraging retirement is effective". (O59).

This respondent went on to say that he would "go along with" a specialist tribunal headed by a QC to deal with insider trading cases. Other members of this observer group identified lack of resources as a problem for the agencies, but one of them was not as charitable when he remarked that "the NCSC whinges about lack of resources". However he also noted that "a determined abuser can afford a better QC" (O64). Other reflections on the agencies were that "the quality of enforcement varies from time to time depending on who is the enforcer" (O25) and that "[the enforcement effort] is probably not adequate because of the difficulty of detection and getting the case to court. The NCSC is developing more credibility but the CAC's are regarded as impotent nit picking bureaucracies" (O5). More pungent criticism came from a journalist who said that the laws are "grossly neglected. The CAC's have inadequate numbers and low quality staff" (O7). Another criticism was that "the laws are defective because of the lack of prosecutions. The Anisman approach was a sledgehammer style; it was too radical" (O34). One commonly made suggestion as to how the law could be more vigorously enforced was that there be a different style of procedure - instead of using the court system "use QC's to investigate and impose penalties with a right of appeal to the courts" (O25). This suggestion was supported by references to several special enquiries into corporate matters which were described as "excellent performances by QC's who are better historically than judges at this sort of thing".

Apart from the naturally defensive answers of the regulators, and, even they were a little ambivalent, the vast majority of respondents showed little confidence in

the adequacy of insider trading law enforcement. It is clear that the CAC's and the NCSC face real problems in the areas of staffing and market surveillance as well as lacking sufficient political support to give difficult areas of prosecution the priority that they may deserve. Although some respondents saw a need to reform or stream-line the law in this area, this was seen as being of lesser importance than the need to prosecute these offences far more vigorougly. For most practical purposes, far too many professionals in the industry felt that there was no law against insider trading, for all the impact which section 128 had. In summary, most people in the industry were of the view that the current level of enforcement of insider trading laws was quite inadequate.

Should there be more vigorous enforcement?

The obvious question to ask following these fairly negative perspectives is whether the insider trading laws should be more vigorously enforced? (Q65). The predominant response from the lawyers was that insider trading laws should be more vigorously enforced. A few however thought that this was not necessary as they did not think that there was a lot of insider trading. A Sydney lawyer answered "probably not as I don't think that there is a lot of insider trading. Insider trading is not one of the big issues that the markets are facing. People should enforce their civil rights, but there is the problem of identifying the existence of trades and of investigating cases. CAC's have bigger things to look at than insider trading, such as hard core company fraud" (L56). Similarly, a Melbourne lawyer answered that he didn't know whether there should be a more vigorous enforcement of insider trading laws. He went on to explain that "...it depends upon how much insider trading is getting through the net. There are those who insider trade unwittingly and those who do it as part of a market operation. The former are having a field day" (L39). However, all other lawyers that we spoke to took a far more positive perspective on the issue of more vigorous enforcement. As one Perth lawyer saw it "insider trading and market manipulation should be more noticeably enforced. However [he added] unless there are obligations to disclose, it becomes difficult to enforce" (L14).

Many lawyers took the view that it was not necessary to reform the insider trading laws but rather to seek to apply them. Thus, one Melbourne lawyer observed "yes; it tends to be a political

solution to reform the law without improving its enforcement. We don't need a total rewrite of section 128, but a will to go on" (L35). Likewise, another Melbourne lawyer noted "Yes; it is amazing for people to say that insider trading laws are inadequate if they are never tested. Even an unsuccessful prosecution will damage offenders" (L36). This theme was continued in Sydney where another lawyer answered "yes [the law should be more vigorously enforced], even if the regulators lose; the CAC's have lost a lot of credibility and power. People don't worry about CAC's anymore" (L55). As another Sydney lawyer saw it "the aim [of prosecution] should be to expose deficiencies in the law" (L57). One reason for prosecution of insider trading offences was often seen to be to publicize the existence and consequences of insider trading laws. As another Sydney lawyer answered "yes, in the sense that its been so neglected that some money must be spent initially on it to remind people [that it is an offence]. There is also a need to spend money on detection to have the appropriate deterrent effect" (L61). Those of the financial advisers who answered this question also expressed the view that the law should be more vigorously enforced.

The picture presented by the reactions of our respondents does not show the enforcement effort in a very good light. It is perhaps significant that there was little direct criticism of the agencies. Indeed, there were some comments that suggested that the agencies were labouring under a heavy burden given their lack of resources and the law they had to enforce. It seems to be a compelling conclusion that if governments are to be taken seriously about their views on the securities industry they must support their rhetoric with some tangible commitment. Otherwise the risk is that the law will fall into disrepute, the agencies will lose the respect that they are working to develop and the market will become as lawless as it was in the late 1960's and the final result will be serious damage to an important feature of the economy.

The effectiveness of the agencies

We further examined attitudes to the regulatory agencies with a view to cross checking the generally negative answers which we initially received. The responses to this subsequent question only served to confirm our original picture. Thus we went on to ask how effective the regulatory agencies were seen to be in dealing with insider trading (Q61). Only one of the financial advisers, for

example, said that they were effective, the majority view was that they were not but some said that they were improving. One view that summed up the position was that

> "they are not at all effective; at the top level the WA CAC is highly regarded but the companies legislation lacks teeth, there is little pressure from the public, stockbrokers do not co-operate and the lack of success must be a factor" (FA17).

Another explained the apparent ineffectiveness by saying that "insider trading is widely known but they cannot get a prosecution" (FA40).

Most brokers also thought that the agencies were not very effective, but some said that considering the budgetary restraints facing the agencies that they were effective. A lack of market skills on the part of the agencies was identified as the major limitation. As one broker put it "they do not know enough about the market. The big players seem to be a step ahead of them - they do things and then have them ratified" (B52). Another broker observed that "to date they are not all that effective. They probably do not understand the industry and need industry experience" (B58); whilst another remarked that "they suffer from a paucity of understanding of the market. Regulation of the securities markets should be a federal responsibility. The NCSC charter is not efficient" (B29). This negative view was confirmed by another broker who told us

> "I am not confident of the NCSC - it suffers from a lack of resources. The NCSC and CAC are not competent and have insufficient market experience. They concentrate on the very easy things like licensing and the hard stuff is being left" (B50).

A more detailed commentary was provided by a Sydney broker who said that

> "the NCSC is relatively ineffective. It has lost its way. It is too obsessed with the notion of victory. It is not impartial and is in conflict with the industry and loses the market's confidence. The CAC is even worse - it cannot hold its staff. The NCSC should be replaced

> with a panel made up of a practising lawyer as chairman, 2 merchant bankers and a broker with a levy on the top 50 companies to pay the chairman's salary" (B54).

Another broker's view was that the agencies "are not terribly effective but I am sympathetic to the NCSC's problems. In the corporate world they do not have much clout. Leave the securities market alone - leave it to the stock exchange" (B32). Others observed that "maybe the teeth have been absent" (B22); and that "they have a tough job and are unable to break through it" (B9). A more critical broker response was that "the NCSC and CAC are pretty ineffective. The stock exchange is good at regulating its members "(B30). The most pungent was that "the NCSC is hopeless - a laughing stock. The CAC is useless" (B49).

There was recognition amongst the brokers of the restraints under which the NCSC and CAC work. As some brokers explained "they do a pretty good job considering the budgetary and staffing limitations and the flawed laws they have to work with" (B8); "the NCSC have surveillance but the system needs an overhaul. The CAC might come down about something but they are not seen in surveillance. They do a good job with the resources they have - they are understaffed and have lost lots of people. The stock exchange is excellent in self regulation" (B48). A Melbourne broker added that "the NCSC, especially, suffers from a lack of facilities. The resources of the CAC's are devoted in the wrong direction. They should decide what is important" (B31). A more optimistic note was struck by a Sydney broker who said "they are improving and would have greater capability if they had more funds" (B47). Some brokers were however prepared to say that the agencies are effective. As some remarked "the stock exchange is able to react quickly. I am impressed by the NCSC - it understands the market better than the old CAC's. There is now much more cooperation" (B44); "they are effective and growing in standing. Their standing is very important for their effectiveness. The NCSC has overcome its earlier debacles" (B28); "they are reasonably effective - they make their presence known" (B37).

But others were not so sure. As one broker put it "I wonder why there are no prosecutions for insider trading" (B10). And one reflected on the structure of the regulators "they have an impossible task under the way they are set up and their structures. A legalistic basis leads to a legalistic response and they lose their moral leadership and ability to influence" (B43). This was also mentioned by a Sydney broker who told us that

> "it is necessary to get rid of the spivs but do we need this structure? It is necessary to balance the red tape. We put up with the bureaucracy of the licensing system. There is so much legislation - some of the regulators do not know about the laws. Who is being protected? The market is mainly professionals - they know the risks of being shafted" (B51).

The majority of the financial adviser group thought that the agencies were not effective in dealing with insider trading. One expressed the opinion that they are not effective in that "the follow through is not good enough and they get bogged down in investigations and in court. Perhaps there should be a market court" (FA33). We were also told that "the NCSC does not have adequate resources nor a good feel for the securities market" (FA62). The factors which were seen to contribute to an ineffective performance were well summarized by one advisor as

> "a lack of teeth in the companies legislation; little pressure from the public; stock brokers do not co-operate; and the lack of sucess must be a factor" (FA17).

More critical comments were that the agencies "are most ineffective - insider trading is widely known yet they cannot get a prosecution" (FA40) and from a merchant banker, "they are incompetent, the quality of staff is low and they do not have sufficient resources" (FA41). This tale was repeated time and again amongst professional advisors.

However, the general view amongst the stock exchange officials was more favourable. There, the agencies were described as "very effective" (R26) and we were told that "there has been a significant improvement in their effectiveness" (R71). Another said "overall they are quite good. The Humes case was the turning point. It would be nice for them to have a win. They need experience to develop skills" (R21). Perhaps the most enthusiastic response was that "the NCSC is lean and mean and I am quite impressed by it. It works under difficulties with a lack of resources. The CAC's are a bit tired and too concerned about trivial matters" (R66). Another ASX official was less kindly disposed when he observed that

> "the agencies suffer from [poor] quality of staff (wages are too low) and lack of experience. The staff of the stock exchange are fairly experienced but could suffer during boom times. Their remuneration scale is satisfactory. I would be quite happy to see staff interchanges between the stock exchange and the agencies" (R18).

Somewhat cryptically, another answered simply "I would rather not comment" (R12).

Views of the agencies held by lawyers were similar to those held by many brokers. One Perth lawyer thought that "they are fairly ineffective as there is no evidence of insider trading" (L13). In a similar vein, a Sydney lawer added that "the regulatory agencies can't be effective. Even if insider trading is rare, four cases in twenty years is bad" (L56). Others saw the failure of regulation in terms of problems of priorities. Thus another Perth lawyer observed "they are ineffective. The record speaks for itself. This is a reflection of the political perception of insider trading and of other priorities" (L14). In contrast, a Melbourne lawyer saw the problem of priorities in the following terms "the NCSC is too concerned with self publicity and law reform, rather than doing its job of enforcement. The heavy NCSC law reform role is inappropriate" (L36). Others saw the problem of regulatory failure not so much as a deliberate product of an effort to give insider trading enforcement a low priority, as due to the pressure of resource constraints upon the regulatory agencies. Of course, this pressure means that priorities have to be set. A Melbourne lawyer explained that the agencies were "not effective due to funding and resource problems and insufficient staff" (L38). Similarly, a Sydney lawyer explained that the "agencies are probably not particularly effective due to a lack of surveillance capacity and budgetry constraints. The CAC's are way out of their depth, but the NCSC has some prospects" (L57). A Perth lawyer expressed a similar view when he pessimistically remarked

> "there is a need for better personnel, of a higher quality. There is also a need for more money, real capacity and dedication. You have to realise that you will lose the first few prosecutions. You need moles. I have no optimism about the ability of our regulatory agencies to deal with insider trading" (L15).

A number of lawyers were slightly more optimistic. For example, one Melbourne lawyer observed that whilst "many insider traders get away undetected, the CAC's very presence has an effect even if there is no prosecution" (L39). This optimism was shared by a Sydney lawyer when he noted that

> "regulatory agencies are more effective that people think, even though they have not been to court. I feel that there is a healthy respect for the NCSC, even though no one will admit to it. This is quite effective. It is good to keep brokers on their toes. The NCSC often uses informal means of enforcement. This is quite effective" (L55).

It is quite clear that amongst professional advisors and traders in the securities industry that the regulatory authorities enjoy a bad press. Perhaps this is undeserved in view of their serious resource constraints. The CAC's in particular seem to inspire very little confidence indeed. The agencies are perceived to lack teeth, competent staff and sufficient resources to adequately do the job that is being asked of them. Many respondents also pointed to the lack of market sense of the regulators, although the courts are also criticised for failing to take commercial realities into account. There was a frequently made call for a more market oriented court comprising experts from this industry, although ultimately the retention of the full sanction of the criminal law was seen as essential. In any event, it is clear that the widely held perception that the regulatory authorities are performing poorly suggests that they need to be given the capacity to "lift their game" in this area.

Detection mechanisms

We were especially interested in the mechanisms used by the CAC's to detect the existence of insider trading as detection is of course the threshold problem. (Q39/44) It was quite clear from the outset that, as one regulator explained, "there is not much pro-active enforcement" of insider trading (R1). There is little to no computer surveillance by the CAC's in respect of market transactions. In this regard, reliance has tended to be placed upon the stock exhange and the NCSC (R2,R19). It was apparent that the regulatory style of the CAC's is almost completely reactive in

nature. As one regulator put it "we rely on tips, the press and references from the NCSC" (R24). This was also confirmed when we asked regulators how frequently they undertook random audits of stock trading for the purpose of detecting insider trading (Q44). The answer to this question was singularly striking and simple. All regulators who answered this question told us that such audits did not take place at all, indicating the overwhelming resort to reactive strategies of enforcement of insider trading. It was amazing that there was not even a hint of pro-active enforcement carried on from time to time.

Information in the financial press can be extremely useful to regulators, as financial journalists are often far better informed of market activity and rumours than the CAC's. However, subscribing to a press clipping service is far from being an adequate basis for market surveillance, although there is little more than this kind of monitoring which takes place in the CAC's. There may be evidence that this is now slowly changing, but there will need to be a major injection of capital into the acquisition of computed equipment, improved staff training and the introduction of better programmes for market surveillance, before this picture will change dramatically. In contrast to the CAC's, the NCSC is somewhat more sophisticated in its market monitoring, but even here, there is much to be desired. It is quite clear that there is a need for a broad range of measures to improve the detection of insider trading. These include the encouragement of more complaints from persons affected by transactions and greater and more extensive surveillance both by the ASX on the one hand and by the CAC's and the NCSC on the other.

Random audits

There appeared to be some confusion among brokers about NCSC enquiries and random audits. It seems that while insider trading related random audits are rare, if they happen at all, there is a considerable volume of enquiries though not necessarily in relation to insider trading. On the topic of NCSC enquiries we learned from brokers that "there are quite a few enquiries from the NCSC" (B47) and that "we are plagued by specific audits from the NCSC" (B43). Perhaps there are some of these enquiries which are related to insider trading - "there are regular NCSC enquiries on trading in particular stocks. The diligence of the NCSC is

surprising and impressive. This is so particularly in takeover code matters" (B50). One broker reported a different experience

> "if there is a hint of insider trading the NCSC raises questions and if not satisfied they will visit the broker. The NCSC will advise the stock exchange people who then come. The stock exchange will always give answers to complaints" (B44).

Brokers also told us about stock exchange enquiries and reported that "the stock exchange does not do many inspections. They are not related to insider trading - they are interested in the system of order taking" (B47) and that "the stock exchange [only] conducts audits of [brokers'] accounts" (B28).

As to the frequency of audits, we were variously informed by brokers that "I have never seen one" (B8); that "there used to be [audits] but it has not happened for a long time. Maybe they are directed to other types of brokers" (B52). We were told that "they used to be regular but not now in the dead market. Pre-crash they came every week or fortnight. It is rare to find one now" (B54). One broker reported that"the CAC's do [undertake an audit] once or twice in ten years" (B28) while another said "during 1969/70 period the CAC were always doing it. I never see them now - the last CAC visit was three years ago. The stock exchange is no longer regular" (B30).

It appears from what we were told by the exchanges that random audits of stock trading are not carried out - "they rely heavily on the Stock Exchange" we were told (R21). An interesting observation was that - "I don't think it is necessary and certainly not by the CAC" (R12). It was not possible to gauge how representative that sentiment was. Similarly, not many of the financial advisers had knowledge of random auits carried out by the regulatory bodies for evidence of insider trading. One reported having had three in the past twelve months (FA16) and another said at least once a year for merchant bankers (FA33) though another of the merchant bankers had never seen one (FA41).

Have there been insider trading cases where no action was taken?

On the question of whether there had been cases which the authorities had detected insider trading but had not

proceeded with a prosecution (Q51) only one lawyer knew of a case and it was one that he had referred to the NCSC. It is interesting to consider the responses of the agencies on this issue - they seem to receive many referrals, some of which are said to be motivated by spite, but each of them is reportedly taken seriously and is investigated but, usually on legal advice, it is not taken to the prosecution stage. In terms of the public relations aspect of their work, it would help the agencies if they were to advise informants of the outcome of these enquiries but perhaps there is an element of confidentiality to be considered. It might be instructive for the agencies to tell likely informants such as the stock exchange what quality evidence is required before the cases can go further. Better still, if there was closer co-operation in this phase the prosecution record might improve.

Nearly all of the brokers said that they were not aware of such instances. In the words of one "they show rare zeal in chasing up cases" (B44). Another was aware of two cases where no follow through had occurred "one where they could not make the case stick and in the other the person left the country" (B52) and another surmised that it was "probably lack of proof" when a case did not proceed (B32). Others have been left wondering "there is no specific case I know of but what happened with the Private Blood Bank?" (B28); "we get a lot of requests from the NCSC for information and wonder what has come out of them" (B48). There appears to be some activity by the NCSC according to one respondent but he went on to say "I cannot think of any [cases where no action was taken] but the NCSC has often asked for details of a trading pattern where insider trading is suspected" (B47). An enigmatic comment in this regard was made by a Sydney broker - who reported that he did not know of any such cases, and went on to observe "but Bosch has the practice of not convicting in some other forms of conduct" (B50). Similarily, most of the financial advisers were not aware of any cases where a case of insider trading had been detected but for some reason not prosecuted. One mentioned the Black Hills case in Western Australia which had in fact gone to court. Another mentioned a case he had referred to the NCSC. We checked with the NCSC about this case and found that it was not strong enough to proceed. In view of the lack of subsequent contact with informers and the apparent lack of understanding of the process of getting a case to court it is hard to attach any significance to these answers to this question.

We went on to ask the government regulators whether they knew of any cases of insider trading which had been detected by the regulatory authorities, but which they had failed to prosecute, for whatever reason. Once again, many regulators reacted quite defensively to this enquiry as it was seen to reflect badly upon their agencies. An affirmative answer was usually only given where it was the case that insufficient evidence was available to support the insider trading charge and not for any other reason. Thus, as one regulator put it

> "all insider trading cases are pursued to an appropriate conclusion. It is important to realize that a prosecution of a person of substance would cost at least a million dollars; such cases always involve QC's and are likely to go to the High Court" (R1).

As another regulator saw it cases had not been prosecuted "where the assessment was that the prosecution could not succeed because of the difficulty of establishing the price sensitive nature of the information" (R2). The CAC's often reported that they had received legal advice that they did not have a strong enough case to proceed to prosecution. As one observed "cases have been discontinued where there is a lack of evidence, usually on the advice of the DPP" (R24); or that "prosecutions have not been proceeded with where the legal advice has been that there is no case" (R20). Another reason for not proceeding was advanced by another regulator when he reported that "all matters are investigated, most are written off because they have an alternative explanation, [or that] CAC's do not have enough information to convince a court" (R67). This can mean that hard decisions have to be made to drop further investigation of a case. As one offical told us

> "several cases have been abandoned on legal advice that there was insufficient evidence; because it is very important to win, the CAC's tend to be conservative. There are additional problems of lack of financial resources. The decisions of the magistrates are discouraging and the real issues have not yet been tested" (R19).

The chances of success obviously weighed heavily in decisions to proceed to prosecution. As one regulator explained

> "the NCSC has an obligation to investigate every complaint. There needs to be at least a 50:50 chance of success before prosecuting. Prosecutors have a natural hesitancy in running cases where there is no precedent" (R68).

When this feeling is added to the problem of resource constraints and the perceived lack of political support for insider trading prosecution, the reason for the lack of more prosecutions is fairly plain to see. More often than not, there was a preference amongst the regulators to proceed in relation to other offences arising under some other provisions of the Code as these were seen as being easier to substantiate (e.g. R69).

The paucity of prosecutions

A central question concerned the lack of any significant number of insider trading prosecutions, with no more than a handful in almost two decades (Q50). Brokers, for example, identified several particular reasons for this. Most commonly it was the difficulties of proof. As one broker explained "insider trading is so difficult to prove [and] it can be explained by other reasons" (B54). Another put it differently "I cannot say but there is a problem of being able to separate what is rumour and what is fact" (B8). According to one "the definitions are not clear enough - what might appear to be insider trading can be explained by a number of factors" (B27). Another suggested that "it is difficult to get evidence that will stand up in court" (B43). A variation of this view was provided by a Melbourne broker who said

> "there is a problem of proof. There would be a lack of witnesses due to the anti-squealer culture and the fear of being cross-examined. Brokers who are aware of insider trading going on would be reluctant to be witnesses for these reasons and for fear of losing clients. Brokers will not complain about each other if insider trading is going on" (B32).

Another Melbourne broker had a simpler answer "people are prepared to perjure themselves" (B30).

We expected to hear that there was a low incidence of insider trading and several brokers confirmed this attitude One reason for its purported low incidence is claimed to be that "insider trading is not a problem in the broking community because of the risk of losing your licence" (B28) and another is that "insider trading involves isolated instances" (B29). We do not however accept these arguments concerning the law incidence of insider trading. Problems with the law were also said to be a factor in explaining the lack of prosecution. According to some brokers the problems arise because of "the vagueness of the definition of insider trading in the Code" (B52) and because "the law tends to favour the accused and delays in the legal system favour the accused. Speed must be of the essence" (B47). Problems in detection are also said to be a reason for the low level of prosecutions. We were told that "it is difficult to trace transactions - it is hard to trace names from what brokers supply especially in relation to overseas transactions" (B50) and it was suggested that "maybe the people cover their tracks too well" (B58).

The agencies were also referred to in this context with resource problems being seen as a factor. Thus reference was made to "the cost of pursuing enquiries" (B37) which was said to limit their success as well as "a general lack of resources in the regulating bodies, including the quality of staff ..." (B48). A broker suggested that there was some hope for an improvement when he said that "until recently the policing of insider trading was not as good as it might have been due to money problems" (B47). Ineptness of the agencies was given by brokers as another reason. According to one broker "in the unsuccessful cases the agencies were not properly prepared and were outsmarted by the other side's lawyers" (B47). Another explanation was that "maybe the agencies are not looking hard enough" (B58). A Melbourne broker offered the opinion that "insider trading is hard to nail down. The NCSC and the CAC lack knowledge and experience and use the wrong techniques. They need people from the industry in the regulating agencies " (B30).

According to the exchange officals, on the other hand, the reason why there have been so few prosecutions is a matter of detection and proof. Only one made the sort of reply we had expected, namely, that it is because there is so little insider trading (R26). There was said to be "extreme difficulty" in detecting insider trading (R71) and that "the elements of the offence are so hard to prove" (R21). Reflections on the agencies appeared in these answers. As other regulators repeatedly observed "proof is most

difficult - an informer is needed. Maybe there is a too hard basket in the CAC's and the NCSC" (R66); and "the authorities do not have confidence in the law" (R12).

The responses from the financial advisers were mixed, but for the most part they identified the major problem as being in the detection and proof phases. An answer that summed up many of the points made was that

> "there are few insider trading offences; it is difficult to detect; there is no incentive for the person harmed to complain; it is not the right people doing the regulating and there is a lack of resources" (FA74).

Another explanation was that

> "the majority of insider trading cases do not involve a significant amount and are therefore not worth pursuing. In any case where significant amounts are involved they are well planned and difficult to detect" (FA6).

There was also some reflection on the agencies "[it must be due to] the lack of effectiveness of the agencies" (FA17); "it has to be a matter of evidence but one would have thought that this was fairly easy to maintain" (FA40). One of the merchant bankers thought that the explanation was quite simple "there is no enforcement" (FA41).

The lawyers' answers fell into a few broad categories. Firstly, the lawyers pointed to problems of staffing and resources facing the regulatory authorities. Secondly they pointed to the problems of proof involved with prosecutions in this area and thirdly, they pointed to problems of approach or will upon the part of the regulatory and prosecutorial authorities. Obviously, all three of these broad sets of reasons are related to some degree. As one Melbourne lawyer explained

> "I hesitate to point the bone at the CAC's, but there is a problem there, maybe due to the lack of resources and to problems in the legislation. They would have some success if they committed the resources. The likelihood of success is presently an issue for the CAC. If

> there were civil sanctions then I would gauge the chances of success as higher" (L35).

Similarly, as a Perth lawyer saw it, the paucity of insider trading prosecutions was "due to a lack of resources dedicated to insider trading. The existing law is strong enough, but the problem is the amount of time it takes to get evidence" (L13). There is a perception that adequate regulatory resources are not being allocated to insider trading prosecutions because it has been seen to have a relatively low priority. Thus, one Melbourne lawyer observed that "there are not the staff and resources, and there has been no real outcry in Australia because it is difficult to show that anyone has lost out of the insider trading. Politicians don't want to understand it" (L38). The rarity of prosecutions for insider trading was seen by a Sydney lawyer as being due to

> "a lack of information and an unwillingness of the NCSC to take on actions and lose. They also don't have sufficient resources, although they do the best they can with the staff they have got. It is important that there be a follow through by the NCSC from its inquiries of brokers" (L57).

These problems were accentuated by the fact that "the monitoring of trading is not efficient enough. There are too many gates for the prosecution to get through" (L14).

Many lawyers also felt that there was a motivation problem on the part of the regulators in addition to these resource problems. As one Sydney lawyer put it "I don't think that the investigators and their mechanisms are adequate to catch anyone. There is a lack of will to follow up suspects and insider trading is hard to prove without a tip-off" (L56). Another Sydney lawyer put it succinctly, when he sought reasons for the failure to prosecute insider trading "it mystifies me. They say it is too hard to do so" (L61). A Perth lawyer was equally blunt, when he remarked that the small number of prosecutions was due:

> "to a lack of motivation and capacity. You can't tell me that there are not blatant cases of insider trading around. But, it is not possible to prosecute in the present climate. There will need to be a couple of losses before they win" (L15).

Problems of proof are significant ones in relation to insider trading offences. As one Sydney lawyer told us "insider trading is difficult to prove and it is uncertain that you will get a conviction. There is also a problem of materiality. Introducing a test of materiality based upon the evidence of a reasonably informed person would not advance the matter" (L55). Another difficulty which was suggested was that "the problem is that insider trading is a question of what is in someone's mind" (L39). Probably the most thoughtful summation of the difficulties facing prosecution was offered by a Melbourne practitioner when he observed that the problems were due to

> "Firstly, a lack of effort; secondly, it is just so hard to get evidence of insider trading; thirdly, the regulators don't have adequate facilities; fourthly, we don't have the depth of regulators which there is in the US. There is not the same acceptance of them in the market here as there is in the US; fifthly, inactivity is also explained by the feeling that the courts won't entertain insider trading cases. Courts have been traditionally reluctant to make inferences from practical commercial outcomes and instead they insist that there should be direct evidence of insider trading" (L36).

Conceivably, one reason for the abysmal record of insider trading prosecution might be that there was not much insider trading activity to be found. We therefore asked the regulators why they felt that there had been so few prosecutions of this type of conduct. Interestingly, no one felt that the lack of prosecutions was due to the lack of insider trading activity. The problem was largely seen as an evidentiary one. There was firstly, the principal problem of getting someone to complain that they had been the victim of insider trading. As we were repeatedly told "people don't complain because they don't know that they have been the victims of insider trading" (R1b). As another regulator saw it "the insider traders all stick together so that there was a need for someone to squeal" (R3), or as another regulator put it "the thieves must fall out" before there would be a complaint (R19). The problem of getting complainants to come forward was seen to be related to the wider problem of obtaining evidence. As one regulator explained, this problem can be traced back to the nature of the market itself "in particular, the practices and procedures of brokers and the exchanges make the exercise of

tracing transactions very time consuming. This official went on to point to the

> "difficulties in obtaining the necessary evidence required to prove this particular offence. In particular, the requirement to show in a positive way that the information was in fact price sensitive and that the defendant was motivated to trade as a direct result of having that particular information. A reverse onus of proof would result in more prosecutions" (R69).

This theme was echoed by other regulators, such as by the regulator who told us that "the difficulty of obtaining evidence and the standard of proof are the main problems. There is a need for a political move to shift the burden of proof to the defendant or to lower the standard to the balance of probabilities" (R68). Governments were repeatedly seen as not being terribly interested in insider trading as a problem (R1 & R23). This was of course related to the further complaint that CAC's had insufficient resources to devote to this area (R19). This was compounded by the failure of the courts to adequately deal with insider trading as a problem. Thus we were told by one regulator that "the courts do not understand the legislation" (R4) and that court rules made the prosecution of insider trading difficult (R69). The complexity of the current legislation was also seen as making the prosecution of insider trading all the more difficult (R70). It therefore seems that the lack of prosecutions is not seen as being due to the absence of insider trading as a problem, but rather due to the problems of detection and proof which face regulators in this area.

The record of insider trading prosecution in Australia is clearly quite deplorable in view of the strong evidence of the continuing existence of insider trading over many years. The regulatory authorities should of course take some of the blame for this. However, the evidence of their lack of will or incentive to proceed vigorously against insider traders has to be matched with the obstacles facing them. The reluctance of professional advisers or business to lend support to substantiate complaints or to act as witnesses has of course served to increase the problems facing enforcement of a law that most acknowledge needs to be more vigorously enforced. The problem of getting persons to come forward to complain about insider trading is compounded by

difficulties of gathering sufficient evidence, especially to the effect that the information was "material" within the terms of section 128. A definition of materiality, based upon the evidence of what a reasonably informed observers would regard as material, is called for. The lack of co-operation with the regulatory authorities from the private sector also suggests a strong case for a close look at a reversal of the onus of proof in insider trading cases.

The detection of insider trading

A key issue confronting the enforcement of insider trading revolves around the detection of insider trading by regulatory agencies. We sought to discover what the main problems facing the detection of insider trading were seen to involve (Q33). The central issue arising in the detection of insider trading is, as we have seen, the difficulty of obtaining complaints or information about insider trading activity. The CAC's and NCSC seem to rely basically upon a reactive strategy, due to the difficulties which a rigorous proactive enforcement strategy would create. These difficulties seem to relate mainly to resource constraints being faced by these agencies. However, for insider trading detection and enforcement to be effective, we were repeatedly told that there was a need for reliable informers who were prepared to come forward with complaints or information. The lack of these presents serious and possibly insurmountable problems and also reflects badly upon the morality or ethics of the marketplace.

As one regulator told us "... the 'clubishness' of business people means that they won't rat on each other "(R2). Another regulator confirmed this when he told us that the main problem involves the difficulty of gathering evidence :"..our experience is that persons in the securities industry will not talk to the CAC "(R1). However, even after detection we were told that witnesses had become unco-operative or had changed their evidence, therefore making the prosecution impossible (R3). As another regulator put it "finding reliable whistle blowers is difficult" (R19). However, we also found that "tips are often not useful; they are non-specific and often involve a question of bitterness. We get hate letters all the time "(R67). It therefore seems that there are serious difficulties involved in the detection of insider trading. These were well summarized by one regulator, when he observed that

"the main problem is identifying the insider trader; the smart insider trader either conceals his identity or gets another person to trade for him. Insider trading may be the perfect crime "(R68). These problems were accentuated where the insider trader used offshore entities to insider trade. This was seen as being a common practice by some regulators (R69).

Even where there was some indication that a person might be involved in insider trading activity, the problems of proof were still seen as serious ones. For example, where the regulators had detected the existence of unusual price movements, it may be extremely difficult to prove that these were due to insider trading. As many regulators observed "the price of shares can move for many reasons" (R1), or as others put it "detection of suspicious market movement is easy, but proving the link to insider trading is difficult" (R19). Similarly, one regulator noted that "share price movement, though suspicious is not enough by itself; it can usually be 'explained' " (R22). Thus the "lack of evidence to link market events with insider trading" (R24) is probably the greatest difficulty facing the enforcement process. Added to this was the frequently made observation that the task of seeking to establish this link was extremely time consuming or labour intensive (R20, R67, R69) and that the agencies lacked the technology for adequate market surveillance (R70). A compounding factor was seen to be the "lack of awareness in the industry" of the problems being faced by the regulators (R23). Whilst there may be problems involved in seeking to prosecute insider trading once it is discovered, it was quite clear that the real problems in this area arise at the detection stage (R23). Further compounding this is the fact that the information trail gets cold very quickly, so that it becomes very difficult to detect or deal with insider trading cases which arose beyond the immediate past.

Problems of proof

This sorry tale was repeated when we pursued this issue further when we asked the regulators what the problems of proof were in relation to insider trading (Q34). Two issues repeatedly cropped up here. Firstly, there was the predictable problem of being able to find witnesses. Secondly, there are real problems involved in establishing that the information available to the trader was price sensitive or that it was material. Looking at the first of these difficulties, we found that "it is difficult to get persons in the market to give evidence as there is a 'no ratting culture' "(R2). This was put a little differently by another regulator who saw evidentiary problems as being of critical importance "because of

the conspiratorial nature of the actions of the persons involved in this offence"(R69). As another regulator went on to add "there is a problem of collecting strong evidence and of getting witnesses to stand by their story" (R3). Yet another regulator explained that "getting a willing witness is a problem as there is not a victim in the usual insider trading case "(R24). Compounding the problem of evidence is the need to be able to find expert witnesses to come forward to help establish that the information used was actually price sensitive. Many regulators reported that this had not always been an easy matter, although we understand that expert witnesses may be just a little more forthcoming now than they were previously.

We also asked the regulators whether professional advisers such as brokers, bankers and lawyers have been supportive of CAC investigations of insider trading (Q43). The characteristic response was that "generally they are co-operative but there is a natural caution to protect their clients" (R68). Put another way, we were told that professional advisors were co-operative "only up to the point where they perceive that they are not going to be personally involved in giving evidence in court"(R69). There was a feeling among the regulators that the professional could be more forthcoming than they were in assisting in investigations. There were some differences between the perceptions of different professional groups. For example, we were told that "accountants and lawyers are very helpful but brokers are less likely to co-operate" (R2). Whilst some regulators saw brokers as being helpful, their co-operation was often dependent upon a search warrant being presented to the professional due to the fear that they might lose their client if they revealed information to the investigator (R24). The general problem facing investigations was explained by one regulator when he told us that "it seems to be un-Australian to help the 'cops' "(R67). This of course is a difficult cultural problem to do a great deal about although it does reflect the existence of a gulf between the regulators and the industry which may be very difficult to bridge.

The issue of expert witnesses is of course linked to the second of the key issues of proof identified above, namely, establishing the element of materiality required by section 128. It seems that the strictness of this requirement is a serious defect in the current legislation and that it may actually be necessary either to spell out more precisely what is meant by the phrase "likely materially to affect the price of those securities" in section 128. Some regulators even saw this as a defect in

the current legislative provisions (e.g. R1). One agency reported that it relied upon a test of materiality which was based upon a 10% change in the price of a security (R20), although this is unduly rigid as price movements will obviously also be affected by the volume of shares traded and the number of shares issued in a company. Perhaps a reasonably informed person test should be introduced along lines similar to those relied upon in this area in the United States. Certainly, the current requirements as to materiality present an almost impossible burden for the prosecution to overcome.

Disincentives to Investigation

The issues of regulatory priorities and the resource constraints which these agencies face leads one to ask how these are dealt with. We did this by asking what the major disincentives were for CAC officers to prosecute insider trading (Q41). Evidentiary problems were the main concerns here. These were seen to lead to "frustration" (R1b), "disappointment with the end result and a disillusion when witnesses change their tune" (R3). The lack of cases was also seen as a disincentive (R19) as there was little precedent and the courts were also seen to take too conservative an approach as a result. Also, as we have already seen "the time taken in detecting insider trading, gathering evidence and getting a result is a disincentive. Resource issues are also involved as there is a need to employ resources in areas where there are more tangible results" (22). These various difficulties were well summarized by another regulator when he observed that "the major disincentives are the difficulty of proof, the lack of success and the lack of experience with insider trading. The US experience should be used" (R24). Put even more forcefully we found that "the low likelihood of success is the major disincentive. Insider trading cases require a lot of work, yet most don't get past the "there is a strong reason to suspect a breach" stage because of the difficulty of proving the materiality of the information" (R68). The complexity of the legislation provides yet another disincentive to pursue insider trading cases. **On the whole therefore, it is hardly surprising that there have been so few insider trading prosecutions over the last two decades. This is clearly an unacceptable situation if we are to be serious about dealing with insider trading in this country.**

Obstacles to Regulatory Co-operation

As regulatory resources are so thinly stretched it seemed to us that there ought to be room for considerable co-operation between CAC's and the ASX in relation to insider trading investigations (Q42). This also seems to be desirable in view of the closer relation to the industry enjoyed by the ASX which might help to ensure that the CAC's were more effective and better informed when dealing with insider trading cases or complaints. Most of the brokers said there were no obstacles, but several of those qualified their opinion. A few said that there would be obstacles but there appears to be a considerable degree of goodwill for the governmental agencies.

Many brokers saw few obstacles to greater co-operation. This was expressed in a variety of ways "I cannot see any. The general view is very anti-insider trading" (B43); "the stock exchange and the government regulators are in the same business - they are not adversaries. There is a very good relationship" (B37); "the industry is eager to avoid blemishes on its reputation" (B27); and "most brokers are keen to see proper regulation and to see a conviction. They want a sophisticated market" (B50).

While brokers saw no problems in principle, a number of brokers qualified their comments. As a Perth broker put it "it is possible to get it to work. It is okay in principle but there are possible difficulties at the practical level" (B8). But, according to another broker it would only work" ...provided that privilege and privacy between client and broker are not challenged" (B28). Some practical difficulties were mentioned "it is pretty well open now. The stock exchange is very cooperative but perhaps there could be more flowing back from the government" (B30) and "currently there is a co-regulation system. The problem is that the NCSC will not put things in writing" (B49). A neat summary of the position was that

> "the confidence of the industry in the regulating body will determine the success of cooperation. Industry has a higher view of the agencies - it was rock bottom 12 months ago. One problem is the role of the NCSC as investigator judge and jury" (B29).

The spirit of cooperation was not however shared by all. As some brokers saw it "people are jack of filling in forms" (B51); "it would be duplication. The best way is to have brokers governed by the stock exchange only. One body would be more effective" (B48). One broker touched on what could be a fatal problem and one that could almost naturally be expected "brokers are ready to cooperate but the regulatory bodies would always encounter obstacles" (B9). The exchange officials were, generally, confident that there could be closer co-operation. One ASX official observed "the stock exchange can provide facts earlier and in eighteen months time there will be a fully computerised market. The NCSC can monitor the market through SEATS" (R18). One problem was identified in the form "of double jeopardy - being penalised by the stock exchange and the CAC" (R21). The most confident statement was that "co-operation between the stock exchange and the NCSC is excellent. We have a marvellous relationship because we are working to the same goal" (R66). A more restrained view was that

> "there is now a fine co-regulatory relationship with the CAC. The NCSC tends to engage in ambulance chasing and we are sometimes distressed by the press release style of operation of the NCSC. The ASC proposal would make it more difficult to co-regulate. The existing CAC structure is appropriate" (R12).

Another ASX branch official was of the view that "there is a need for a greater degree of co-regulation" (R71).

On the whole, we were told by the CAC's that where there was an ASX branch in the jurisdiction, there was already generally a good working relation between both organizations. Although in the past we were told that there had been "an us and them attitude", things have improved considerably since then (R1). However, the ASX was seen as primarily dealing with the NCSC and not with the CAC offices (R19). Both organizations were seen however to be facing resource constraints "but in all the circumstances, the NCSC-ASX relationship is excellent" (R68). The real problems facing both organizations were external ones, not internal, for as one regulator told us "the working relationship is very good. The problem is really one of detection as the Australian market is hard to monitor" (R67).

The Standard of Proof

In addition to the problems of proof which the terms of section 128 itself creates, another difficulty arises from the fact that the criminal standard of proof beyond reasonable doubt exists in this area. We asked the regulators whether a different standard of proof would make prosecution easier (Q35). Whilst some thought that the prosecution would clearly become easier, many had doubts about taking this approach. If a civil standard of proof on the balance of probabilities was introduced it was felt that the penalties would necessarily have to be changed. This was seen as unacceptable to most of the regulators. One reason was that if a civil standard were to be introduced the sanction of imprisonment would have to be abandoned, but that this was unacceptable as, if this were to occur, "the principal deterrent would cease to exist" (69). However, as another regulator observed "businessmen don't go to gaol" (R67) so that it is far from clear that the threat of imprisonment is acting as an effective deterrent at the moment. Also, a number of regulators added that even if a civil standard of proof were to replace the current standard you would "still need to obtain the evidence" (R2) and that "it would still be necessary to prove the elements of insider trading" (R4). **A common suggestion offered at this point was that rather than lowering the standard of proof, a more effective strategy might be to reverse the onus of proof (R67, R68), and therefore require the accused to prove that his or her conduct did not fall within terms of section 128. Whilst this might be seen as politically undesirable, it may well be the only realistic solution to adopt short of a re-write and relaxation of the current legislative provisions. These provisions have clearly been almost impossible to enforce and this problem is seen to be made all the more difficult by the strict attitudes of the judiciary to charges brought under this legislation. Some regulators saw a "need to educate the judiciary" (R4) whilst others saw them as lacking a grasp of the nature of market realities in this area. These are problems which clearly need urgent attention if we are to be serious about prohibiting insider trading.**

Resource problems

Related to the issue of the priority given to insider trading by the regulatory agencies was the frequently raised issue of resource constraints. We pursued this matter further by seeking information regarding the main resource constraints upon the

CAC's which affect the detection and prosecution of insider trading (Q38). Interestingly, we were repeatedly told that there was not a resource restraint as such, but rather that this was more a question of emphasis, either by government or by the agency itself. As one CAC commissioner told us, "this is more a question of emphasis; the government decides what resources are put into CAC's. Priorities are then internally determined; this will depend on the level of complaints" (R1). A senior regulator in another State put it similarly when he told us that

> "this is more a question of government emphasis. State governments collect revenue but do not put it into the CAC's. The level of computerization, for example, is deplorable" (R22).

The inadequacy of the regulators' computer monitoring capacity was raised time and again. Another issue of resources which was repeatedly raised was that of insufficient high quality staff working in the CAC's, although this problem was ultimately seen in terms of the lack of adequate funding of these agencies. We frequently heard that "CAC's have difficulty retaining good staff" (R2) and that the "good staff leave for private enterprise" (R19). The NCSC was seen as not having sufficient staff dedicated to the area of market surveillance and that its staff "lack market savvy" (R67). The staffing problem is really more serious than it seems as the nature of insider trading is such that "it is necessary to move quickly to be successful against insider traders" (R19), and there usually are not the staff available to devote to this area. As one regulator explained, "there is no lack of will but a lack of time as only one or two from every forty or fifty cases investigated will be worth prosecuting" (R68). **However, whilst resources constraints are clearly a serious problem facing the regulatory agencies dealing with insider trading, it is probably true that these are not the main problems which confront dealing with insider trading in Australia, although it is clear that increased resources would help considerably in dealing with the problem of market surveillance.**

Regulatory Priorities

We then turned to seek information regarding the priority which was given to dealing with insider trading (Q40). On a day to day basis, most regulatory agencies give a low priority to dealing with insider trading. One major exception to this is the NCSC. One

regulator told us that at the NCSC, "insider trading is given as high a priority as resources allow, although 40% of all matters investigated involve some element of insider trading" (R68). A national regulatory official told us that "insider trading has a serious priority and is seen as an essential element in the creation of investor confidence" (R22). However, in the CAC's, insider trading is given a low priority due to the pressure of other more immediate matters, unless of course a clear case of insider trading is brought to their attention. In the latter event, we were consistently told that insider trading would be given a high priority. Thus, as one regulator told us "a complaint of any substance would get top priority. However, in [this State] there are 60,000 companies to be regulated, plus 156 prospectuses to be examined in 1987; these labour intensive areas use most resources" (R1). As another put it "insider trading is one of a number of issues and is given no special priority" (R2). However, most went on to add that "once an incident of insider trading is identified, it is given top priority" (R4) or that "if a case comes up it is given top priority because of the high penalties involved" (R19). However, there is no "watching brief" for insider trading offences held by the CAC's. Thus we were told that "on a continuous basis insider trading has no special priority and there is no staff member assigned specifically to insider trading. However, any specific complaint of insider trading is given high priority" (R24). **For most purposes, the following response is probably quite characteristic of CAC officials "insider trading is given a low priority because it is resource intensive, while the criminal standard of proof makes conviction difficult" (R67). On the whole, a depressing picture for anyone concerned with the enforcement of securities legislation in this country.**

Regulatory Goals

Pursuing the policy objectives of insider trading regulation a little further we were concerned to distinguish exhortative or aspirational statements of policy objectives from more realistic assessments. We therefore asked respondents to select from three particular policy goals, the goal which they thought to be the most realistic (Q11). The three goals which we put to them were "punishment, orderly marketing or symbolic reassurance".

The opinions of brokers were split slightly in favour of symbolic reassurance over orderly marketing. Punishment was not seen as a realistic goal. One of the very few comments made in response

to this question was that "no client would be aware of section 128" (B37).

Most of the stock exchange officials saw orderly marketing as the most realistic goal, one said that it was a mixture of this and of punishment, whilst another thought it was merely symbolic reassurance. There were some limited expansions of these answers. For example, we were told by ASX officials that section 128 is there to "... provide reassurance to the public that the industry is reliable" (R18) and to "provide necessary ethical standards" (R21).

The financial advisers were also split in their opinions as to the most realistic goal of insider trading regulation. They fell into two camps - orderly marketing and symbolic reassurance. One of them commented that "the legislation is too wide in that it tries to provide consumer protection as well as regulation of the operating processes of the market" (FA74) and he was not able to nominate a particular goal.

Orderly marketing was identified by the observers as the most realistic, slightly ahead of symbolic reassurance. One view, in favour of orderly marketing, was "I hope it is better than symbolic reassurance and punishment comes too late" (O5). Perhaps the most realistic response was that "insider trading will not be eradicated even with Anisman type rules" (O53).

Similarly, no lawyer thought that punishment was a realistic goal of insider trading regulation, although it has to be said that this purpose is not necessarily incompatible with the others put forward. As one Sydney lawyer put it "it can't be punishment as no one is ever punished" (L56). However the punishment goal should not necessarily be regarded as being irrelevant, for as another Sydney lawyer noted "insider trading regulation deters people and scares a lot of people who are thinking about it" (L55). A Perth lawyer added "deterrence should be achieved, but at the moment it is just a symbolic measure" (L13). Of the remaining options, orderly marketing was selected as the most realistic goal, whilst symbolic reassurance came a close second. Some saw it as a mix of both of these goals. However, as one perceptive respondent observed in answer to this question "punishment for its own sake has no value. An orderly market should prove attractive to investors" (L15). A Melbourne lawyer succinctly emphasized the predominant orderly marketing goal of insider trading regulation when he noted

> "we assume that protecting widows and orphans is economically efficient, but I don't agree. If you said it is Rafferty's rules, it would lead to a disorderly market and inefficiency" (L35).

Turning to the governmental regulators, most saw the realistic goals of insider trading regulation to be primarily those which we referred to as orderly marketing, although punishment was often linked to this goal in some way. However a few regulators had little doubt that there was also a good deal of symbolism in the goals of insider trading regulation. As one saw it "[the most realistic goal is] totally symbolic; the market knows that nothing much is being done" (R1a). Another regulator took a similar view when he observed "since no one has ever been convicted, the practical view is that the regulation is largely symbolic" (R1). However, most saw the symbolic goal as being less than adequate. As one regulator remarked "re-assurance is the goal, but it is more than symbolic; and this is of course connected to an orderly market" (R22). As another confirmed "orderly marketing is the goal; deterrence can be effective here because businessmen lose their respectability and their livelihood if prosecuted" (R23).

Realistically, therefore, very few interviewees saw punishment as being a purpose behind insider trading regulation. Most felt that the provision of a system of orderly marketing is the most realistic goal of regulation. To a slightly lesser extent this was linked to symbolic reassurance, which came a close second as the most realistic goal. As no one is ever punished, or at least perceived to be punished, punishment does not figure as a realistic goal of regulation, except in so far as it is necessary for purposes of orderly marketing or symbolic reassurance.

Part 2 - Insider Trading Law Reform

Several aspects of the legislation were considered in the range of our questions where we tested the reaction to possible changes in the law and, in one respect, the legal process.

Tippee liability

One of the perennial problems with our insider trading laws which have particularly worried brokers, has been the extent to which they are to apply. In other words, who is to be caught by them and how far the law should go in defining tippees. The Anisman report dealt in some length with tippee liability. In looking at this issue (Q23) we found a predictable tension between casting the net too wide and so giving regulators a considerable discretion as to which cases to pursue, and on the other hand, codifying the classes of tippees more precisely. There were mixed feelings about these choices.

The answers from the brokers fell into three categories - a definite "no", a qualified "yes" and "no view". Those who did not agree with such a change offered much the same reason "it should be aimed to get the originator" (B51) because "at the lower levels the credibility of the information is so low" (B28). It was interesting that only one reference was made to the fiduciary principle, and this was by a Perth broker who said "restrict [tippee liability] to those in a fiduciary position" (B8). Another view was that "it is pretty clear what the intentions of the law are - nobody in the stockbroking community or in corporations misunderstands the law. If the law started pointing at specific groups it would damage confidence" (B44). And some saw practical problems with an extension of tippee liability. As one broker put it "in the purist sense - yes - but practically - no" (B10). A Sydney broker said "I cannot see what is achieved by doing this. It is very difficult to identify the class of person who engages in insider trading" (B49) and his view was shared by another who said "go back to the originator - you cannot go all the way down" (B58). A simple response was that "an extension is not warranted" (B72).

Most of those who favoured exhaustively spelling out tippees did so with qualifications. As a Melbourne broker explained "you could never legislate to cover every contingency. Restrict it to the originator and associates and any professionals involved" (B30). Two Sydney brokers had no difficulty with the concept but entered reservations on practical grounds. One said that an extension was appropriate "to put people on their mettle about the

risks involved. But I am not sure how far to go" (B52). His colleague said that "it would be very useful but there could be the risk of missing somebody" (B50). A limited degree of support came from a Melbourne broker who said "it should probably be more specific but do not go so far as to round up everyone within cooee" (B37). One of the Perth brokers was in favour of an extension in principle but he warned that "if you go too wide the law would not be enforceable" (B9). Only one was confident enough to say "go all the way" (B31).

The "no view" group pointed to difficulties in taking this course. One Sydney broker took the position that "this issue requires deeper exploration. Lots of innocent people could be caught. Vicarious liability would be too much; get the people who are directly involved. Look at the facts of each case - those indirectly involved should not be caught" (B48). We learned something of the way the market operates from a Sydney broker who said that

> "this raises a problem of how information is transmitted by the insider - there is a problem for the client adviser who innocently recommends a particular stock. Whether you exhaustively define tippees depends on who you refer to. Brokers get far less tips, people giving them tips are more circumspect. People giving tips to individuals are more likely to be in the deal" (B47).

We were also told that "you need to be careful how far down the chain you go" (B54). One broker said "I am not sure. The lack of convictions affects my judgment" (B43).

There was little support from the exchange officials for the idea of an exhaustive definition of tippee liability and no support for the Anisman approach. One view was that the "down the chain" approach should not be used and that the existing law should be used by "proving that the person who received the information knew that it was inside information" (R66). We were told that "Anisman reached ridiculous combinations" (R18) and that

> "Anisman's tippee chain went too far in that it was fallacious to assume that information was always confidential. It is wrong to create an infrastructure that supports a dubious definition" (R12).

On the same subject, "it is important to get the definitions right - Anisman's approach was to broad. It is a difficult area" (R18).

Those of the financial adviser group who agreed with the proposition said that "no damage would be done by broadening the base" (FA16). Some saw it as serving a positive purpose "the legislation should define a tippee. Many people do not see themselves as insiders and a list would help" (F40); and that "in the absence of case law a list of tippees would help" (FA42). The broadening of the base of tippees had another supporter who said "corporate responsibility should be for all staff. If the information is being passed on as inside information then the person should be liable" (FA16). But that was not widely shared - "the broad definition of tippees was a reason why the industry did not take Anisman seriously. How far do you go"? (FA33). Likewise, we were told that "a much less ambitious approach is more likely to succeed" (FA6) and the the "definition of recipient should be broadened but not so as to catch associated persons who take shares as an act of faith [in their clients] (FA17). One suggestion was to leave the matter as is because "section 128 does well enough" (FA60).

In contrast, one Perth lawyer told us that the provision "should be defined widely as it is narrowly interpreted" (L13). This view was confirmed by another Perth lawyer when he said that "judges set out with a mental bent against prosecution". He went on to add that "we should reverse the onus of proof, i.e. put it on the person who has the knowledge to show that he is not a tippee" (L15). Most lawyers however seemed to be happy enough with the present definition. One practical solution to the question of whether a list of tippees should be set out was made by a Melbourne lawyer when he said

> "it might help to attack the area by having a list of tippees issued by the NCSC as guidelines. But, you may not need to spell it out in the legislation. However, the present legislation should first be tested" (L36).

The retention of the present approach to tippees was also supported by a Sydney lawyer when he said

> "I am happy with the current broad definition; it is more flexible. I don't know that certainty is such a good thing in this area.

> There are advantages in having degrees" (L55).

The regulators tended to oppose any attempt at seeking to definitively define the category of tippees. Generally, this was seen as being "too difficult" (R1b) or as having "practical difficulties" (R1), and moreover, many felt that section 128 was already broad enough (R4, R19, R20). Some felt that there would be too many evidentiary problems involved in "casting the net too wide" (R69) or that they could not "see how an exhaustive definition would help" (R24), although the advantage of a different definition was seen to be that of catching non-fiduciaries (R2). On the whole, the Anisman proposals in this regard, which led us to include this question in our survey, were seen as amounting to "overkill" (R22) or as being "too wide" (67).

When we asked the market observers about tippee liability we received almost as many answers as there were members of the group. Two said that the law should be aimed at those in fiduciary positions (O25,5). Another said that the law should exhaustively define the categories of tippees but "this is of lesser significance than enforcing the existing law" (O53). Others said "aim at the originator and tippee" (O34); "leave it to the judge to decide" (O64). Another took the view that the definition should "cover all sorts" (O7). There were two reflections on the Anisman approach "[he] went beyond the obvious groups. It is necessary to define the core of insider trading. To catch an analyst who is trading on research is too tough" (O46). The other said that

> "Anisman was carried away on this topic. If tippees are classified it could lead to problems. Anyone with sensitive or undisclosed information is a potential tippee. There are a great many problems in defining tippees. Regular disclosure by companies is the solution. Companies in sensitive industries should undertake quarterly announcements, not accounting, as a matter of routine" (O59).

On the whole therefore, there was not a great deal of support for an overly precise legislative definition of tippees. However there may be a case for the NCSC preparing guidelines in this regard.

The Issue of Materiality

One of the components in section 128 that must be proved is that the information "would be likely materially to affect the price" of the securities in question. We asked the brokers, financial advisers and stock exchange officials how they would measure materiality and we tested the US approach to materiality, namely, whether a reasonable person would consider information material.

Brokers were almost unanimous in stating that "it is a complex matter". Most felt that a flat percentage formula would not be appropriate, and that market conditions, the particular share, price and volume movements and the established trading patterns must be considered. There was some support for the use of a percentage movement but not by itself because "it would move the price up to the legislated rate" (B51). The techniques and the data for examining trading patterns appear to exist. We were told that "you have to look at the trading patterns and the volatility factor as options traders do" (B29) and that "if it goes beyond the established pattern of trading that is material. The industry now has a deep history of companies" (B37). Brokers variously expressed "no opposition to" (B54); "agreement with" (B52); "acceptance of" (B50); and "comfort with" (B58) the notion of the reasonably informed person test. One broker thought such a test was "fair" (B43) and another thought "it might work" (B51).

There was almost complete accord among the exchange officials about the unsuitability of a simple equation as a means of measuring what is material. Even those who quoted a percentage went on to say that other factors had to be taken into account, such as trading patterns, price volatility, the particular shares in question, the state of the market and historical data. Perhaps their reaction can be summed up by this comment

> "an equation is not the way to do it. Other factors affect the price of shares for example the position in New York, the price of gold and so on. The reasonably informed person approach is acceptable" (R66).

Rather surprisingly when we asked the financial advisers how to measure a material change in price a number suggested a simple percentage. Those who were closer to the market, however, rejected this approach. The matter was probably best explained by one of the merchant bankers who said "this is related to the volume of shares available, the price at which they are selling and

the degree of liquidity in the stock. For BHP $1 is a material change but in other companies 1¢ might be material. There is no formula" (FA41).

It is clear that a broad definition of materiality based upon the reasonably informed person test ought to be looked at very seriously in Australia.

Changing the standard of proof

The regulators were asked whether a change from the criminal standard of proof would make the task of prosecution easier (Q35). The detailed responses to that question were discussed earlier. There was not a high level of support for this change, the major reason being that the existing range of penalties would need to be altered as a consequence and that the deterrent value of prison would be lost. Changing the standard would not alter the need to gather evidence and to prove the case in court. An alternative that emerged was that of reversing the onus of proof so that the accused would need to prove that the conduct was not within the range of section 128. A change of this nature might be very difficult to sell politically but if the lack of enforcement is properly due to serious difficulties in making cases stick then it is an option that requires further serious consideration.

Part 3 - Self Regulation

If regulation by existing regulatory agencies is widely seen as being wanting, it might be asked if self regulation is likely to be a more effective response to insider trading in the Australian context. This is an option that must always be considered particularly in a climate of deregulation. The developments in the United Kingdom since the "the big bang" and the emergence of "people's capitalism" also place this option on the agenda of any possible reform. As one Sydney lawyer observed "we have de-facto self regulation anyhow, we have it with lawyers" (L61). However, is there a case for a more extensive system of self regulation to deal with insider trading? (Q18). A comparison is often made with the model of the regulation of financial markets found in the City of London as a result of the Financial Services Act of 1986.

Attitudes to self regulation

It appeared that many of the brokers were not aware of the system in the United Kingdom and their comments largely reflected views about self regulation based on the stock exchange as the regulating body. Opinions were fairly equally divided. Some of those who thought it would be more effective referred to the value of self interest in making it work (B72) and the ability of the exchange to suspend companies where there has been insider trading (B9). We were told by a Melbourne broker that it is best to "leave it to the stock exchange. They have the skills to detect and investigate. The stock exchange is highly computerised and insider trading can be tracked down" (B30). Other expressions of support included the opinion of a retail broker in Melbourne who said that "it probably would if handled properly. The stock exchange wants to convey to investors that it is safe. It would be better than big government" (B27). His view was endorsed by another Melbourne broker who explained that "self regulation is preferable - it is driven by the interest in maintaining a market. For controlling insider trading, futures and options should also be included. Self regulation could be tougher and more likely to turn up breaches" (B31).

A strong statement of support came from a leading Sydney broker who said that "the system in the UK with more suasion is very effective. The SRO's are expert in securities; the NCSC is not as expert. I believe absolutely that it would be more effective" (B54). Another Sydney broker strongly supported self regulation on the basis that "the expertise in the stock exchange is far in

excess of other regulators - they are closer to the operators. The efforts of the stock exchange in its regulations, articles and by laws is excellent". He went on to point out that "the problem is with regulating people outside the industry. It might not be practical" (B48).

But there were as many who did not think it would be more effective. Speaking of the system in the United Kingdom one broker explained that "the system in England works because of the role of the Bank of England. Without that it will not work in Australia" (B32). Another view was that regulating insider trading was beyond the reach of the stock exchange "it is not the preserve of the stock exchange. The NCSC is the right body. The stock exchange should report to the NCSC" (B29). A senior Melbourne broker went so far as to doubt whether insider trading was properly within the ambit of self regulation. As he put it, "to the extent that insider trading is a problem it is theft and as such is not within the ambit of self regulation. It is difficult for the stock exchange to do more - how can you identify the buyer? With more automated trading there is greater facility for co-operation with the authorities" (37). This reservation was shared by a broker in Sydney (B49).

It was often suggested that self regulation is not effective - "I am not sure that self regulation is as good as it is said to be" (B51) and the ever present problem of public confidence in self regulation systems was referred to by a Perth broker who argued that "it should be regulated by some government body. There needs to be independence for the public to have confidence" (B10). The ability of the stock exchange in regard to self regulation was also doubted

> "the London panel is a wonderful process. To understand insider trading a panel would help. The stock exchange is not likely to devote funds for the technology to monitor insider trading. Based on its performance with accounting systems the stock exchange could not do it" (B50).

The existing system works according to a Melbourne broker who said that "I am comfortable with the current situation" (28). The same sentiment was expressed by a Sydney broker who believed that "the existing system is sufficient - the stock exchange controls only the brokers" (58). Only one exchange official supported the idea while the others offered a variety of reasons as to why it was

not suitable in this country. A neat summary of the issues was put to us in this way

> "the stock exchange could not reach the non-brokers. The current scheme is a form of co-regulation. The stock exchange would support the elimination of duplication between it and the agencies. The Australian culture is different to that in the UK due to the role of the Bank of England (R18).

This view was reflected in the words of another ASX official who explained that "the stock exchange can reach only its own members. The insider traders are the entrepreneurs and the directors and they are not reached by the stock exchange" R21). The need for some form of education as to ethical obligations was indirectly referred to by one official who asserted that "it is unrealistic to expect people to self regulate where they may be unaware of implications" (R71).

A limited degree of support for self regulation was recommended by one of the ASX regulators who remarked that "the stock exchange does not want to be responsible for self regulation of insider trading but does want self regulation for brokers. The stock exchange would regulate brokers who were engaged in insider trading" (R12). The only strong supporter of the idea claimed that "the UK system is the only way to go" presumably because" regulators here do not understand the way the market works e.g. how brokers do things". He went on to say that "if there is self regulation it must be reviewed and the system must be accountable. The stock exchange tends to go too far in its penalties" (R66).

There was not a great deal of support for self regulation among the financial advisers. The difficulties were perhaps best summed up by one of the advisers who said

> "the industry is mainly conducted by honest people and self regulation can be effective but there is a difficulty with inward looking regulation and criminal sanctions and some outside investigations are still needed" (FA74).

A more forthright view was that "laissez faire capitalism must be regulated as a response to the greed factor" (FA16). Along similar lines was the opinion that

> "in the Australian securities industry self regulation is pathetic. Players have varied and vested interests and without pressure from the NCSC the stock exchanges would be pathetic. Self regulation in Australia has traditionally been tokenism" (FA40).

One expressed the fear that "stock exchange persons who are inside traders would make the rules against insider trading and this would be a sham" (FA11). A merchant banker put it this way "reputable people already self regulate. It is better to have no law than one which is never enforced" (FA41).

Despite their reservations about the existing system and their support for the principle of self regulation only two of the market observer group did not think that self regulation alone was a realistic alternative. One reason for it not being supported was that "brokers are interested only in making money - they are driven by greed" (046). Another pointed out that "self regulation is only good if you make it stick. You can't have voluntary observance" (059). A more detailed view was expressed by the former broker who said that

> "the stock exchange has always had self regulation but it was suspect because of being run by brokers. Some of their decisions were motivated by commercial reasons. The Bank of England is a major factor in the London exchange. We need a mixture of regulation by the stock exchange and the NCSC" (065).

Similarly, we were told that "an independent body is needed. It is very hard to operate a disciplinary system. It is essential to have public confidence. There is room for a mixture" (05). Yet another criticism of the self regulation approach was that "insider trading is not adequately policed at the stock exchange level" (025).

Whilst many of the lawyers thought that there was a place for greater self regulation, the applicability of the London model was all too often questioned. As one Perth lawyer put it

> "the situation in Australia is very different from that in the UK. There are old boy networks there. You don't want a Star Chamber where there is no recourse" (L14).

A Melbourne lawyer explained this reservation concerning the London model a little further when he observed "the City of London lends itself more readily to self regulation as it is more concentrated. But here, because it is so separated, self regulation would not work by itself" (L35). A Sydney lawyer added further to this point when he remarked that

> "the problem with Australia is that unlike the UK, there is no single market here. Attitudes and ethics in the two markets are different" (L57).

This was also the view of a Perth lawyer who thought that "there is a different financial tradition in the UK. My experience tells me that it would not be like that here if brokers took control" (L15).

There were mixed views about the abilities of the Stock Exchanges to regulate their members if a self regulatory scheme were to be developed. One Sydney lawyer was prepared to be confident about the abilities of the Exchange as a regulatory vehicle when he noted that "the current scheme of regulation doesn't work. The Stock Exchange would probably be more effective amongst brokers, but not across the securities industry generally" (L56). However, this view was very much a minority perception amongst the lawyers. One Perth lawyer observed

> "self regulation would be more effective, but I wouldn't be overly confident that the Stock Exchange could improve its enforcement. The Stock Exchange should police its own, but there are problems with this" (L13).

This viewpoint was put even more forcefully by another Perth lawyer when he argued that

> "Stock Exchanges are hopeless! Brokers don't have a lot of integrity at the moment. I don't think that brokers are effective self-regulators. Self regulation would be Rafferty's rules. Other professions don't have the same training in moral principles as

> lawyers do. You can justify anything by saying that the market justifies it. This leads to anarchy and no rules. We need to see a lot more integrity demonstrated by brokers, who are a greedy lot generally, before self regulation would be possible" (L15).

This fairly negative view was not confined to Perth. As a Melbourne lawyer, for example, told us

> "I am disappointed with the Stock Exchange as a self regulatory organization. It has been erratic and inconsistent in applying the listing rules. Self regulation would not solve the problem. The NCSC needs to grow, it needs experienced staff and funds. Exchanges have too many conflicting interests leading them not to pursue people. They just go quiet" (L35).

At best, it was often suggested that self regulation should be added to supplement the present system of regulation. A Melbourne lawyer argued that "Stock Exchanges ought to take a real interest in this area, but not to replace CAC's as the ASX is not capable of adequate self regulation" (L36). A Sydney lawyer also remarked in respect of self regulation "I would add it. It doesn't matter if there was self regulation so long as who was doing it was active" (L55). However, most lawyers did not seem to be too confident in the capacities of brokers or the Exchanges to regulate the insider trading of their members.

Perhaps not surprisingly, the regulatory officials were predominantly quite critical of the self regulation of the securities market in the Australian context. Even those who liked the idea of self regulation, did not hold out too much hope that it would prove more effective than current regulatory approaches. Thus one regulator told us that "I personally favour self regulation but doubt that it would be effective". He went on to argue that whilst it was "very important to deregulate, there would still be a need to maintain some regulatory backup" (R2). A similar approach was taken by another regulator when he observed

> "I would like to think that persons in the industry could be trusted to self regulate but self regulating organizations are slow to grasp the opportunity. Self regulation is an

> experiment worth the effort, but probably would not work as de-regulation would occur" (R1).

Interestingly these two regulators came from the same agency, but they were the only regulators who saw any merit in self regulation as a strategy in this area. Most of the remaining regulators were somewhat more blunt in their responses to this question. As one of these regulators saw it "self regulation is an irrelevant debate in Australia; it just would not work" (R22). The reasons for this scepticism were fairly consistent, and these seemed to relate to a poor regard for the integrity of stock brokers in one way or another. At one extreme, the view was taken that "stockbrokers are involved in insider trading up to their ears and would put the interests of their clients first" (R1a). At the other extreme, it was felt that "the stockbrokers are not insider trading themselves but do business for and with the insider traders" (R67). This was presumably meant to refer to the conflict of interests which this would involve. This latter theme was elaborated upon in the remaining responses which concentrated upon the perceived inability of the stock exchanges or industry groups to effectively regulate their members. This was generally put in terms such as the following "I am not a great believer in self regulation as there is a conflict of interests between the motives of the self regulating bodies and the public interest" (R24). Put a little differently, another regulator explained "self regulation is remarkably weak and ineffective; it is necessary to have a regulatory body which is not part of what is being regulated" (R23). In regard to the stock exchanges, it was felt that they "did not have the resources to regulate the activity" of insider trading (R1b) or that they would at best be able only to suspend or fine their own members but would not be able to impose penalties "to deter companies and company officers from insider trading" (R4).

We sought to cross check our responses from the regulators by asking them if, in their experience, insider trading could be more effectively controlled through a system of industry self regulation (Q36). Once again, however, the pattern of response was much the same. A few regulators felt that there may be advantages in self regulation. We were told that self regulation was desirable "because the industry must be seen as honest by the public. The industry is moving in this direction and the Stock Exchange has improved its image since the 1970's" (R2) Another regulator thought that it might "be easier to gather evidence if there was self regulation" although he went on to say that he was "not sure

that the ASX can be trusted to co-operate" (R22). Another thought that self regulation by resort to professional standards of conduct was appropriate, but he said that he believed that the costs of self regulation were quite high (R67). Apart from this mixed support for self regulation as a means of dealing with insider trading, most other regulators felt strongly that self regulation was not likely to be very successful in this area. A characteristic response was "how can all the players in the market be self regulated? Brokers are easy to control, but what of directors and entrepreneurs. Are the Stock Exchange listing requirements sufficient here?" (R3). Partly, the problems of self regulation were seen in terms of resources. As one regulator told us "self regulation would not control insider trading. Although the ASX and NCSC co-operate, it is doubtful if industry has the resources to be self regulating" (R68). It was generally believed, however, that non-resource issues were of greater significance. Thus, one regulator explained "the industry is concerned with providing the market facility and could not perform an enforcement role in any effective way , as a government body can" (R69). Put somwhat more emotionally "self regulation would not be effective for stockbrokers as they are up to their ears in wrongdoing" (R1a). There was some respect for the activity of the ASX, although there were still many regulators who were a little wary of handing over complete responsibility to it for self regulation.

As we saw with our direct query as to the appropriateness of self regulation in the Australian context (Q18), there is little support for the introduction of self regulatory structures in this country similar to those found in the United Kingdom. This was largely due to the significant differences which were perceived to exist between the two countries geographically, and between their financial markets and practitioner cultures. Nevertheless we went on to explore the self regulatory structures which are already in operation here and factors which might impinge upon their effectiveness.

Conflicts of Interests

We asked all of the participants about the frequency of conflicts of interest arising from access to price sensitive information (Q24). Lawyers had little trouble identifying the intent of this question, whilst many of the non-lawyer respondents we spoke to seemed to experience some difficulties in coming to terms with the notion

of conflict of interest. Obviously this could not be because conflicts of interest only arise in relation to legal work.

It appears that conflicts are part and parcel of a broker's working life especially for those engaged in corporate advising. The ability of brokers to manage these conflicts would be an important consideration in deciding whether self regulation could be introduced. Those brokers who commented on this matter were as one in saying that they are resolved quite properly. According to a Melbourne broker "nine out of ten people would not exploit their position" (B30). And, as a Perth broker told us, the problem "is solved by ethical rules" (B9). The approach of a senior and respected Melbourne broker is that "you must order your affairs to handle it. It could be a time bomb but so far we have been able to resist the temptation" (B43); while a Sydney broker took the view that "if it happens you wear it" (B47). One of the Melbourne brokers felt affronted by the suggestion that brokers are unable to manage conflicts and he told us that "sharebrokers live with it every day. We are not here for the day - do not govern us as thieves" (37).

The question evoked a variety of responses from the stock exchange officials which suggested that perhaps they are not close enough to the market work face to have experience of the problem. One perceptive comment, however, was that despite the various measures taken to avoid conflicts "ultimately one person in the firm must know everything and thus a conflict arises" (R66).

The answers to this question from the financial advisers indicated that conflict of interests was a frequently occurring phenomenon but, surprisingly, there was no information provided about how they are resolved.

The market observers thought that conflicts would be common. One of the journalists who shares this view went on to say that "it is acute where a merchant bank advises a company. The window of opportunity approach is an uneasy solution; managers and directors are most exposed" (O46). Another of the journalists expressed the view that "brokers tend not to think of conflicts, it is a matter of low ethics. It could happen to people close to the company" (O64). The one observer who commented on the resolution of conflicts said that they are "usually resolved properly" (O5).

As one Sydney lawyer explained "lawyers recognize conflicts readily and don't do it, but non-lawyers find the problem of conflict of interest hard to understand" (L61). Most lawyers reported that conflict of interest situations were very common. The law firm lawyers felt that this problem was particularly acute amongst brokers and company management. As one Perth lawyer put it "conflicts of interest regarding price sensitive information must occur all the time with brokers and they also occur with directors who are share traders" (L13). Another Perth lawyer also noted, "for management it is inevitable" (L14). A Melbourne lawyer confirmed this when he said that "conflicts of interest are a continuing problem for company directors" (L39). A leading Sydney takeovers lawyer summed up the situation quite well when he explained that in

> "legal firms there is a lot of potential for conflicts of interest, although actual conflicts are rare. Brokers have a more practical approach to conflict of interest, i.e. they don't handle conflicts well. Merchant bankers do better. Banks are pretty good at keeping information to themselves" (L 56).

One solution to the problem of conflict of interest in relation to share dealings was offered by a Perth lawyer when he told us "conflicts of interest don't happen to me in relation to share trading as I don't share trade" (L 15). This may well be an appropriate solution for many others in conflict of interest situations, at least in regard to trading within specific periods around company announcements.

Some regulators reported that such conflicts did not occur within the CAC's. As one regulator observed "this doesn't happen in the CAC as any such information is immediately disclosed to supervisors. It must however be more frequent in the private sector" (R3). Others thought that problems with conflicts of interest would be influenced by "the size of the organization and the particular persons involved, e.g. geologists" (R4). Another regulator echoed this view when he told us that "such a conflict depends on the circumstances. It is more likely with professional directors and advisers" (R19).

Some reported that they had no experience with conflicts of interest in the handling of price sensitive information but the realistic view was that such conflicts were commonplace. As one regulator explained "this must be common: there are only four or

five top notch merchant bankers, it follows that there must be conflicts of interest" (R22). Likewise, we were told that "such conflict is probably quite frequent, it depends on the opportunities which arise" (R24). Another regulator went on to pursue this theme of opportunity again when he observed that such conflicts of interest were quite frequent in corporations. He went on to explain that

> "persons having access to the price sensitive information by virtue of their position within the company either delay telling their shareholders or alternatively, they acquire or dispose of shares prior to the release of the price sensitive information to the relevant stock exchange. Similarly, friends or relatives of this particular person may also benefit" (R69).

The Handling of Price Sensitive Information

We asked all respondents whether their organizations had any procedures for the handling of confidential information. In other words, what kind of self regulatory structures they had in place in their firms or organizations (Q19-21).

There are several forms of procedural arrangements within broking firms which indicate that there is recognition of the problems that could arise from the misuse of sensitive information. The extent to which firms take precautions depends on the firm size, whether it undertakes conflicting work such as corporate advising and, for some, on their international affiliations. The usual arrangements are that staff are required to sign undertakings; staff trading is permitted subject to scrutiny by senior members of the firm; there are Chinese Walls; in some cases the firm is organised into divisions such as trading and corporate divisions and in some of these firms there is a physical separation of the divisions; restrictions on the flow of information are common; meetings procedures are designed to avoid conflict; in firms that also operate in London there are compliance officers to satisfy London and to prepare for the "inevitable introduction" of that requirement in Australia. Breaches of the rules about insider trading are said to result in dismissal from the firm. A number of brokers made the point that it is also necessary to develop a culture of ethical conduct within the firm. In the words of one "the example set by the leaders is vital" (B32). While the responses to this question indicate that brokers recognise the

problems of the misuse of information what cannot be measured is how well the procedures are policed, particularly at the lower staff levels, and how effective they are in practice.

There is a mixture of procedures employed by the financial advisers. Very commonly there are restrictions on trading either in the form of embargoes or the requirement to obtain permission from a senior staff member. Information is often transmitted on a need to know basis and, in one case, the organisation goes to the extreme of having sensitive documents typed by directors. One of the accountants said that his organisation relies on the ethics and integrity of the staff but also takes the precaution of a term in the employment contract to protect confidential information. Some respondents rely on Chinese Walls and another has physical security arrangements. Two of the merchant banks have Chinese Walls made up of separate offices in different States. It appears that the various rules are expressed formally and informally. In one case because of its international operations one organisation has very strict formal rules designed to satisfy the requirements of regulators outside Australia.

All of the exchange officials demonstrated concern about this issue and have procedures in place within their own organisations. Some are informal and rely on the people involved and an assessment of their integrity while, in one, the procedures are formal and rigorous - "staff handling sensitive information are restricted - they sign secrecy provisions; they, and their wives, cannot deal without the approval of senior staff and brokers are not able to process their orders without the appropriate documentation" (R18).

Because of the nature of their work many of the market observers do not have this problem. One journalist said that "there have been opportunities to engage in insider trading but it is a matter of ethics for the individual journalist and what is used is very much a personal system" (O5). Another journalist took the view that the "only way journalists can work is by printing whatever information they get" (O7). In an oblique way this response touches on the vexed question of disclosure of information from the company to the public. The one member of this group who had to face the problem said that, in his organisation "very few people have access to price sensitive information. Staff would be dismissed if they were dealing on inside information or breached company ethics" (034). This policy is no paper tiger as we found out when another respondent in the study, quite unprompted,

mentioned the particular company as one that takes seriously the problem of insider trading.

A range of different philosophies and approaches were evident in the different large law firms that we visited. The common thread which ran through all the answers we received from the lawyers in them was that, ultimately, they relied very heavily upon the professionalism of their staff to ensure that confidentiality of price sensitive information was maintained. For example, one Perth lawyer told us "you endeavour not to talk about highly confidential information. It all comes down to individual discretion" (L15). Similarly, another Perth lawyer remarked "having professional legal staff makes it easier to deal with confidential information" (L14). A Sydney lawyer put it succinctly, "when you set up a lot of systems you create problems. The best thing is just to shut up about it. You rely upon the partner's integrity". He went on to explain that "we don't need to prohibit trades in client firm securities as we are usually insiders [and so are caught by the section 128 prohibition]. We are not investment driven and our partners are not investors, as our primary business is law" (L 57).

Some firms did not believe in setting down formal guidelines for the handling of confidential information, whilst others did have some such rules. One Perth lawyer told us that "we don't have any formal guidelines as to how information is to be handled as only a few practitioners are involved with price sensitive information" (L14). On the other hand, another Perth lawyer observed that

> "as a whole the firm is very conscious of confidential information getting out. We use sealed envelopes to partners and we lock away confidential information. We are zealous about keeping client information confidential, for example, we use pass words on take-over documents and we have security doors around the floor" (L13).

There seemed to be a similar concern amongst Melbourne lawyers. For example, one of them remarked that

> "we have felt that sometime there will be a prosecution which would lock in a lot of people. That could be damaging to a large law firm. We therefore have a series of guidelines

> for the firm. For example, you are required to inform the managing partner before you buy or sell securities and you can't act [for a client] until you get a clearance" (L36).

Conflicts registers are increasingly popular in these large law firms as we also found in Sydney. Thus one Sydney lawyer told us "we have a conflicts register. Also, information is only made available upon a need to know basis. But we have no register as to our shareholdings and there is no prohibition against our trading in client securities, although we are well aware of section 128" (L 55). Another Sydney lawyer reported

> "in takeovers, the senior partner keeps a register of potential conflicts of interest. We will only act for one party to the transaction. We keep files inaccessible to others in the firm. If there is a need for someone to know about something we tell a senior partner who knows a minimum amount of information" (L56).

Some flexibility is seen to be essential at times. For example, whilst law firms have Chinese Walls, particularly as they have become larger, these are rarely inflexible structures. One Sydney lawyer observed "having Chinese Walls does not mean not talking to someone as you may need to bounce things off other professionals". He went on to reveal that "where two of us in the firm took instructions [from each side to a transaction] one of us arranged for another to act. We [also] run a register of interests. We come close to a stock trading prohibition, although we have no rule that we can't invest in the stock of our client companies" (L61). Whilst it can be said that most of the procedures for ensuring the confidentiality of client information held by large law firms are fairly informal and rely heavily upon the professionalism of legal staff, it is probably the case that the large law firms seemed to be somewhat more fastidious in this regard than any other group that we interviewed.

Regarding the regulators, we found that they relied heavily upon normal governmental secrecy procedures in the handling of confidential information. Thus we were told that the secrecy provisions of the NCSC Act and of the Public Service Act covered these circumstances (R1b). We were also told that they relied upon the fact that "as part of the staff induction process, staff are asked to sign to secrecy provisions of the Public Service Act and

the NCSC Act" (R20) and "each person is made aware of their obligations under the Public Service Act, the NCSC Act, etc" (R19). Reliance was also placed upon the integrity of individual staff members and we were repeatedly told that "information is only distributed on a need to know basis" (R3, R4, R24, R69). A number of regulators reported that they had confidence in the effectiveness of these procedures as there had not been any known failures in these systems, although one added that "of course, sophisticated electronic eavesdropping was possible" (R1). In any event, efforts were also made to isolate the handling of takeovers matters from other areas of the workload of the CAC's and this was seen as being effective (R1a, R20). The same deliberate restrictions of information were seen to apply to information gathered by the investigations divisions of the CAC's (R69). **We were not, however, in a position to assess the effectiveness of these procedures as sufficient cross checks were not made with persons outside the CAC's who might have been able to provide a perhaps more objective or critical view of the operation of the internal CAC procedures. However, if overseas experiences are any guide, the security of information may be just as much at risk in government agencies as it is in the offices of private sector professionals. This is something which deserves closer scrutiny than we were able to provide in this study.**

Chinese Walls

Another issue which we pursued under the broad heading of self regulation concerned attitudes and experiences with Chinese Walls. We asked interviewees how much confidence they had in Chinese Walls as a means of preventing insider trading (Q22). It should be noted that section 128(7) (b) of the Securities Industry Code provides that it is a partial defence to an insider trading charge if a body corporate "had in operation ...arrangements to ensure that the information [in the possession of an officer of that body corporate] was not communicated to that person and that no advice with respect to the transaction was given to him by the person in possession of the information." In other words, having a Chinese Wall can be a partial defence to an insider trading charge.

Among the brokers there was little unqualified endorsement of Chinese Walls as a procedure for preventing insider trading. Even those who thought them to be useful went on to say that their effectiveness depends, ultimately, on the people behind them. One broker merely said "I am extremely confident of them" (B31)

but most of those who were confident of them based that assessment on their experience of the Chinese Walls in their own organisation. One Perth broker told us that "they work here", giving as an example a case where the dealers were not aware of a company float with which the firm was associated (B9). Both internal and external discipline will make them work as it was explained to us "it works well here because of the integrity of the staff. The client would be lost if there was a leak. They can be relied on outside. The Chinese Wall is part of the system of self regulation" (B28). The threat of market punishment was also reflected in the answer of a Melbourne broker who told us "ours works and others would probably be good. You cannot afford to allow unlimited access. If a firm leaks the client punishes" (B27). The secret of a successful Chinese Wall was explained to us in these terms "it depends on the ethics of the firm - it is not the structure but the commitment. Confidence in them is growing as professionalism grows" (B43).

There were, however, those who expressed less than complete confidence. "Our Chinese Wall works in this office but outside the office social contact can break it down" said a Sydney broker. A similar feeling was expressed by an experienced broker who told us that "the idea is good and they work in my experience. The Chinese Walls depend on people to make them work and loose tongues are a problem" (B58). Some of the limitations are that "people will try to get around them" (B10) and "they will work if you want them to work. The integrity of the people involved is vital" (B32). One of the Sydney brokers told us that "I am sceptical about grapevines. You can never be certain that people will not take advantage of the information" (B49). Almost damning with faint praise was a senior broker who said "they are not worth a bumper. They are as good as the rules and integrity of the people involved. But they are on the right track" (B37).

The particular circumstances of a firm were often identified as vital to the success of a Chinese Wall. As one very prominent broker explained,

> "it works here - there is very high security. It has to work to maintain business. Others do not work as well due to the low standards of some people. The market will sort it out quickly if there is a leak" (B54).

A similar opinion was held by another who said that "it gets down to the individual and you must rely on their integrity. You cannot

disclose deals - there are problems with the number of people involved in the office. It is an occupational risk" (B51). A comment not made elsewhere was that "the major area of breakdown is at the government level". (B52).

Some brokers said quite definitely that Chinese Walls do not work. In the opinion of a Melbourne broker "they are almost impossible to administer and it depends on the culture of the organisation" (B32). An even stronger expression of disapproval came from a broker who, in other respects, was inclined to tell us that the market is almost perfect. He described them as farcical and went on the say that "they cannot work in practice and are easy to overcome. The inspection of Chinese Walls by the stock exchange is relevant to insurance" (B44). A blunter assessment of them came from a Melbourne broker who said "they are useless. They will not work" (B30). Perhaps the most thoughtful response was that

> "I have no confidence in them at all. To avoid any problems you do not do any conflicting business. People talk, especially senior execuitves. There is a natural desire to find out information from within the firm" (B50).

Not one of the financial advisers expressed unqualified confidence in Chinese Walls. Those who had no confidence used terms such as "farce", "no faith" and "as effective as a sieve". Others made the point that unless there is a clear geographical separation they will not work. We were told by one merchant banker of his experience with the much vaunted Chinese Wall of a stockbroker when, on his way out of a meeting with the broker, he overheard a discussion of that meeting being conducted by the broker's secretary. Those who expressed qualified support stressed the importance of the integrity of the staff for the success of a Chinese Wall.

When we asked the observers how much confidence they had in Chinese Walls only one of them expressed any (after we told him what Chinese Walls are). They were variously described as "superficial and not really effective" (O65); "generally a joke built up by brokers as an illusion" (O64); "unrealistic in view of the need for information to flow" (O75). As to their effectiveness one said that "it depends on the firm. With solicitors they are very impressive but I am considerably less confident about merchant banks and stockbrokers" (O53). Another said that "it depends on the integrity of the institutions. Some ethical people try to make

them work". (O46). But one of the journalists was less kind "it is staggering that people pretend about them. They do not work". (O7). In the words of another "they cannot be relied on - self interest would ultimately destroy them" (O5). One observer whose position led us to expect a vote of confidence reacted by saying

> "I am not too keen on these strategies - they do not help to overcome insider trading. There is a great deal of artificiality about them. It is essential to maintain honesty. Governments cannot legislate for honesty but they can legislate against dishonesty" (O59).

The comment that best expresses the opinion of the stock exchange officials was that "they are not perfect but are better than none" (R12). Several repeated the comment that Chinese Walls ultimately depend on the integrity of the people behind them. One official made the important point that "there are some very difficult practical problems arising from Chinese walls such as writing cheques and keeping records" (R21).

Most lawyers had a lot of regard for Chinese Walls although they repeatedly told us that they work well only if you want them to. As one Melbourne lawyer told us "their effectiveness depends upon the people involved and their level of professionalism" (L39). Similarly, one Sydney lawyer told us "Chinese Walls are essential. They work. But there are instances of breakdown. They are as good as the people who operate them" (L57). Another Sydney lawyer put it this way, "Chinese Walls can be quite effective if properly run. It all depends upon the organization running them. They work well in reputable houses" (L55). Likewise, a Perth lawyer took the view that "it comes down to how well policed they are and how they are regarded within the organization. A good example rubs off on others" (L13). Some lawyers had little confidence in the effectiveness of Chinese Walls in dealing with insider trading. As one Perth lawyer put it

> "I've never seen a Chinese Wall without a grape vine growing over it. I really don't have much confidence in them. If you know that the information is there then there are ways of finding out about it" (L15).

A Melbourne lawyer also observed that "Chinese Walls won't be adequate where there is a real conflict of interests or where a

conflict is unavoidable" (L35). One solution offered was that Chinese Walls would only be effective if there is significant geographical separation between the two parts of the organisation. Thus one lawyer said of them that "Chinese Walls are fine between an office in two cities but are impossible within the same physical location" (L39). In contrast, one Sydney lawyer thought that full geographic separation was not necessary if the Chinese Walls are properly set up and people are systematic about them. As he went on to say

> "Chinese Walls work well in some well organized brokers offices and merchant banks. Lawyers are worse at setting up Chinese Walls than merchant bankers, but brokers are the worst. Chinese Walls are more than a fiction if you take them seriously" (L56).

Another Sydney lawyer told us that "geographical separation by a floor is okay" (L57). The following view of another Sydney lawyer is probably quite representative of the lawyers that we spoke to

> "it depends upon where the wall is located. In a broking office or merchant bank, the mere existence of a Chinese Walls is not enough. It comes down to the individuals involved. Merchant banks' Chinese Walls are probably not as good as people say" (L61).

Although some regulators felt that Chinese Walls can work in some situations, most had little confidence in them. One of the former group felt that "the effectiveness of Chinese Walls depends upon the standard of probity of the organization". But he went on to note "the porosity of Chinese Walls" (R10). As another regulator saw it "Chinese Walls are okay in a large firm if the firm values its reputation" (R2). This view was confirmed by another regulator who noted that "Chinese Walls are probably okay in large firms but not much use in the smaller firms" (R70). The final observation in support of the value of Chinese Walls was that "Chinese Walls work if they are genuinely constructed; however, some are there only for the cosmetic effect" (R24).

The other senior regulators were far more critical about the potential effectiveness of Chinese Walls. Some of these observations were quite colourful. We were told that "Chinese Walls are very thin and superficial. Lots of people have a price" (R1b); or as another put it

> "I have no confidence in them; the grapevine would still flourish. Chinese Walls are a last resort and it is dangerous to rely upon them" (R19).

Whilst it was acknowledged that Chinese Walls may be relatively easy to set up "they are difficult to police" (R22). One reason for this lack of confidence in this type of "procedural architecture" is that "the securities industry is very "gossippy" (R23). The most telling response was provided by another regulator who observed that "Chinese Walls don't exist! I went to see one and couldn't find it" (R67).

The Monitoring of Trading

We were interested to know whether as part of their self regulating practice brokers (especially) monitored trading for evidence of insider trading (Q55). One broker told us that he sees every trade in the firm (B10) but, it should be said, his is a small operation. Very few of the other brokers said that they monitor trading for this purpose and those who do are mainly interested in the trading activities of their staff. The only reference to the conduct of clients was that "if clients said that they had inside information we would be concerned but otherwise would not enquire" (B48).

Some brokers monitor trading but not for insider trading. As one explained "I do not but I monitor volume and could identify insider trading. Brokers will not ask clients about insider trading" (B54). One who monitors does not do it "specifically for insider trading but I monitor the price and volume of situation stocks and will often trade on the back of that" (B50). Another form of monitoring was of "trading in companies that are well thought of by the firm and in whom a large number of clients have invested" (B37). It would be surprising if brokers were not keeping a watch on market trends and this seems to be the case judging from a comment from a broker who told us "I watch turnover like a hawk looking for any sign of corporate activity" (B44). Some said that they conduct a "subconscious" form of monitoring and typically "if a client acts out of character, enquiries might be made and it could go as high as the most senior level in the firm". According to this broker though, "people who insider trade are more likely to work through a number of brokers" (B32).

What might be the most realistic approach to monitoring came in the form of comments from two brokers one of whom said that he did monitor the market "but not for insider trading. What interest does the broker have? Who is interested in the results?" (B58). The other pointed out that in the real world "it is not profitable. The only monitoring is of clients and their ability to pay" (B9). And there is probably a lot of truth in the attitude of a Sydney broker who told us "it is not our job" (B47).

The answers from the stock exchanges suggested that there is no concerted attempt to identify instances of insider trading. Monitoring is undertaken in a general way - to find indications of any unexplained or unusual activity - but it appears that with one exception no stock exchange has dedicated resources for this purpose.

Two of the fund managers said that they monitor the market for signs of insider trading closely and scrupulously. The merchant bankers do not monitor as a matter of routine but would do so if requested by a client.

Insider Trading and Risk Taking

A basic question which faces all schemes of regulation is the perception of market actors of the risks of detection and prosecution. When we looked at this issue, we asked whether insider traders tend to assess the risk of detection and prosecution to be so low as to be worth taking (Q14). We were attempting to establish whether the marketplace perceived that the formal regulatory structures were ineffective and we also wanted to measure whether insider trading was done in a calculated way without regard to its illegality or to ethical considerations. The answers to this question could also provide a guide as to whether self regulation would work in practice.

Presumably because they do not know any persons who engaged in insider trading, most brokers said that they were unable to give definitive answers to this question. Most of the answers were either guesses or general observations. One broker explained the process by saying that "it depends on their morals. The risk of detection is lowish; of prosecution, low and even if found guilty the penalty is low" (B47). A more definite answer was that "they do if they understand the risk" (B50).

There was a body of opinion that insider trading is not riskless. As it was put by a Sydney broker "they are motivated by the

rewards. The risks are not low"(B44). He was supported by the observation from a Perth broker that "NCSC surveillance is very effective" (B10). Another Sydney broker believed that "currently there is a degree of exposure. There is more than enough reason to be careful" (B48).

Two of the brokers gave us their impressions of how insider trading is carried out. A Sydney broker believed that "those who are more likely to do it are fairly well up the corporate ladder and have a lot to lose. They would not buy in their own name" (B51). A Melbourne broker said that

> "the average person would not give detection a moment's thought. Their biggest concern is tax. The big operators calculate the risks and do it offshore all the time" (B30).

Another commentary on the style of insider traders came from a Sydney broker who told us that "those with criminal minds do not worry about the penalty. They expect not to be caught and are concerned only with profit" (B58). Several brokers said that they could not answer this question but one Melbourne broker suggested that "many people go through a process of rationalisation and overlook the impact on others. They are self focused" (B43). Another told us that "you must look at each case" (B31). Some of the others thought that the insider traders do not even think of the risks and the opinion of one broker was that "most of those who do it are ignorant of the law" (B52) and he gave us the example of site workers.

We were told by those exchange officials who were able to answer this question that some people do it not knowing that insider trading is illegal but those who know it is against the law would assess the risk. One official provided this insight into the mind of an insider trader - "they would not do it otherwise. It is characteristic of any criminal activity" (R66).

It appears from what we were told by the financial advisers that, if they are aware of the legal significance of what they are doing, those who engage in insider trading do so having assessed the risk of detection to be so low as to be worth taking. As one put it "professional investors would but "Mrs Smith" probably does not know about insider trading" (FA6).

The way it is done was explained by three of the merchant bankers. According to one of them "persons who frequently

insider trade are aware of the risks and go to great lengths to avoid detection. The risks of detection would be higher if there were people investigating and enforcing" (FA60). A more detailed explanation of the process was provided by a Melbourne banker who said

> "there are three levels of insider traders; the disreputable end of the market who will insider trade despite the law; those who do not rely on a licence to trade and are prepared to risk being caught; and those who do rely on a licence and set up structures to avoid being caught" (FA41).

He was critical of the low level of enforcement and drew the analogy with speeding - "if there are no police about drivers will speed". An other merchant banker told us that "I do not think that people strictly analyse the risk but the general perception is that the risk is low" (FA62).

The predominant view among the observers was that they do make the assessment that the risks of detection and prosecution are low or at least do not worry about the risk of being detected. An interesting observation made by several of this group was that some people who engage in insider trading are not aware that it is a crime. Those who make the assessment are "those who do it on a large scale" (O25) and they not only make the assessment but "they cover their tracks" (O7).

Interestingly, we found that most lawyers felt that whilst some insider traders would probably think this, most would probably not even go to the trouble of worrying about the risk of detection and prosecution. As on Perth lawyer saw it, "everyone thinks he can get away with it. They pay lip service to the Code, but then ignore it "(L15). Similarly, a Melbourne lawyer gave a characteristic response when he answered, "subconsciously they may do this, but they never really think about it. They talk themselves into believing that the market is aware and don't give section 128 much thought" (L 38). Another Melbourne lawyer similarly answered "but most wouldn't even go through that mental process of assessing the risks on insider trading" (L36). Further explanations for this somewhat cavalier approach to the threat of legal action against insider traders was provided by the Sydney lawyers. Thus, one answered "yes, if they thought about it. Instances of insider trading are not clear cut to people involved and so they don't think of it as insider trading" (L56). Similarly,

another Sydney lawyer explained that "until the prosecutions of recent years, most people have not contemplated prosecution" (L57). Presumably, he was referring to the prosecutions of insider trading which had occurred in the United States in recent times. Finally, a Sydney lawyer observed that whilst some insider traders would look at the risks of apprehension "others would do it anyhow, either because they don't care or because they don't know that it is a crime" (L61).

If we turn to the responses of the regulators to this question, a similar pattern also emerges. Most simply agreed that insider traders assessed the risk of detection and prosecution to be so low as to be worth taking. We were told that "this is blatantly done" (R3), or that, "there would be many who would do this" (R2). As another regulator explained "most traders are aware of the lack of successful prosecutions. If there are no records or witnesses then the chances of prosecution are low" (R24). Others felt that there were also many insider traders who did not make this kind of calculation due to their ignorance of the law. As one regulator saw it

> "there may be some people who assess the risk this way, but most people are not aware that what they are doing is the offence of insider trading" (R20).

Put a little differently "there are clearly some people who would so assess the risk, while others are merely reckless or naive" (R1). One regulator thought that there was little element of a deliberate attempt to break the law by most insider traders. As he saw it, "I doubt that there is a conscious decision to do this. I think it is more a question that they justify their acts to themselves and console themselves with the idea that even if they are caught out, they will be able to come up with a good explanation"(R69). It may be, however, that insider trading has in recent times begun to be perceived a little differently, for, as one regulator reported, "my impression is that ten years ago such activity was considered risk free, but now it is seen to be risky" (R23). In fact, we were told that the NCSC has been attacking the intermediaries who assist traders to insider trade and has counselled them to leave the industry where they have been involved in insider trading. We were reliably informed that during 1987-1988 more than ten such persons had left the industry as a result of such counselling. It is not clear however, what effect this regulatory strategy has had upon traders generally.

Professional Attitudes to Insider Trading

We continued our enquiry into how self regulation is practised in real life by asking about the attitudes of professional advisors to insider trading (Q27/ 63). It was no surprise to hear most brokers tell us that the attitude of other professionals to insider trading was one of propriety but there were some who took an opposite view. Some others said that insider trading was not often discussed, if at all. The 'proper' attitude was explained to us terms of ethics. In the words of a Melbourne broker "people are totally ethical" (B37). That view was echoed by a Sydney broker who told us that "there is a high professional ethic. Lawyers and merchant bankers do not insider trade even though they have the chance to do it early" (B48). In support of the "generally pretty anti" attitude we were further told that "most people are thoroughly decent" and, anyway, "nobody would openly boast about it" (B43).

But it is not only ethics that generate an attitude against insider trading. As a well established Melbourne broker told us "there is genuine distaste for people who indulge in it - they are not the people you want to do business with" (B28). A more down to earth approach was revealed in the answer of a Sydney broker who explained that "everyone is very conscious of any conflict of interest. Nobody wants to be dragged off to court. They are fully aware of the laws and the stock exhange rules" (B44).

Perhaps the attitude to insider trading is a function of size and location. A Sydney broker said that "the bigger firms are very careful about it" (B52) and another of the brokers, from a large firm, told us that "some small firms especially during the boom get 50% of their income from rumour linked trading" (B47). This same broker said that "most people are against insider trading. They seek to maintain market integrity." He then went on to say with some embarrassment that "in Perth I daresay even our own firm makes money from insider trading".

Those who disagreed said of their professional colleagues "they know it happens and there is a degree of acceptance of its prevalence" (B8). A Sydney broker's view of the people he deals with was that "lawyers are exemplary - they understand the law. Investment managers are a mixed bag" (B50). That assessment was not shared by a Melbourne broker who offered the opinion that "perhaps they all rely on it to some degree" (B30). An even more direct answer was provided by a Perth broker whose impression of his colleagues is that "they are greedy" (B10). We

were told by several brokers that insider trading is not often discussed but, even so, "it is considered to be not proper behaviour" (B32) and, according to a Sydney broker, "everyone is aware of the law" (B51). A Perth broker indicated that perhaps in that city there is an element of gallows humour about the subject "nobody spells it out. They tend to joke about it" (B9). We were given a pragmatic explanation of the brokers' attitude to insider trading by a Sydney broker who said that

> "brokers are generally ethical and in any case are not so stupid as to engage in insider trading. It is wrong to say brokers are best placed to engage in insider trading - they are the prime suspects for investigation - the lack of cases illustrates this" (B29).

The stock exchange officials told us that they thought that there is a generally shared opposition to insider trading. There were, however, some qualifications expressed. One official told us that "[they] say it is not acceptable but perhaps there is some tolerance" (R21). Another believed that "brokers want to stamp it out but do not want over wide regulation" (R18). An intriguing comment on the topic was that "there is a deep feeling for the pragmatic aspect" (R12) which might be interpreted as meaning that insider trading is tolerated as a fact of market life and that the horror expressed about insider trading relates more to being caught than to breaking the law.

The most common response from the financial advisers was that insider trading was either not much discussed or never discussed even though "it is not a taboo subject". According to one "I have never asked, all stockbrokers know who are the rogues" (FA17). Another said that "I have not discussed it much. Professionals know it is illegal and some do not see it as wrong" (FA40). From those who had an opinion we learned that "views differ" (FA6) and that "respectable professionals would not risk their career or reputation to insider trade" (FA41). A fund manager told us that "insider trading is seen as illegal if done with mens rea" (FA11). According to a merchant banker "lawyers and accountants are aware that insider trading is illegal and unethical but brokers are not so good" (FA42). A more definite view was that "insider trading is not tolerated and is discouraged in a corporate, cultural sense" (FA33).

The observer group repeated the view that insider trading is not often discussed. As one journalist said "like incest, people do not

talk about it" (O7). One person, however, reported that "it is mentioned often in generally condemnatory terms. Certainly nobody says legalise it" (O59). Another said that the attitude was tolerant "but they are appalled by the more flagrant abuses" (O5). A senior journalist said that "ethical persons are anti insider trading and have a low opinion of those who engage in it" (O25). Perhaps the most thoughtful commentary on the topic was that

> "some are appalled by it and say that it needs to be regulated. Others say that they are under peer pressure to do it. Some people are making money from it. The attitude reflects their own values" (O53).

The most characteristic response from the lawyers was that insider trading was rarely if ever discussed. Sometimes that was because the lawyers knew that the other professionals did not like hearing about the subject. One Perth lawyer told us that "brokers don't like it much when it is discussed" (L14). Similarly, a Melbourne lawyer told us "most people express abhorrence if the topic is ever raised, so it rarely comes up. Brokers don't like it to be raised" (L36). Another Melbourne lawyer observed "we are very cautious of any transaction which has a smell of insider trading. Brokers sometimes would rather not know about it" (L39). However, talk of insider trading is not a taboo subject as two Sydney lawyers told us. As one put it "everyone says it goes on, but no client of mine does it. There is not much discussion of it amongst professional advisers. Sometimes by raising it, there may be a reaction, but there is no general taboo against doing so" (L55). When it is raised, one Melbourne lawyer noted that "merchant bankers and brokers are more inclined to ask if they will be caught, not whether it is against the law. Smaller brokers would not survive if they did not insider trade" (L38). Similarly, a Perth lawyer told us that talk of "insider trading doesn't upset brokers a lot. Insider trading is part of people's dealing activity" (L15). Of the professional groups that lawyers had to deal with, they had the highest regard for the ethical attitudes of accountants who were seen as being "more conscientious about it" (L13), and that their strictness about insider trading was "due to audit requirements" (L57).

We also asked the regulators what their experience was of the attitudes of professional advisors to the practice of insider trading (Q43). Whilst some reported that it was rare for this issue to come up in their informal discussions with professionals in the private sector, this was probably because the CAC officials were seen as

policemen rather than professional colleagues with whom matters of mutual interest and concern were discussed. It seems that professionals are quite careful about discussing insider trading with CAC officials. As one regulator told us

> "in front of the CAC chairman the usual response is one of shock. Privately, however, professional people are tolerant of insider trading and probably participate in it" (R2).

Another senior regulator observed "I would hardly expect them to speak about insider trading to the CAC chairman" (R24). As one of the other regulators observed "they are usually careful when talking to the CAC, but bankers expressed a surprising degree of hostility to the Anisman Report" (R19). We were told by others that "the attitudes of professional advisers range from tolerance to encouragement" (R4). However, whilst some regulators felt that "most [professionals] are in it" (R1a) others were able to tell us that "most of the market is honest, especially the professional advisers, though there are some who will be tempted to break the law" (R67). **It could be concluded that the regulators have a natural suspicion of the professionals in the industry and that it seems that this attitude may be reciprocated on the part of the professionals. However, there is clearly a view amongst the regulatory sector that insider trading does exist to varying degrees amongst the private sector professional, although this seems to be more at the level of suspicion rather than being based upon hard evidence.**

We explored this issue further by seeking from our lawyer and accountant respondents information concerning their perceptions of the ethical standards of their fellow professionals regarding the prohibition against insider trading (Q63). It has to be realized that the legal profession is far from being a uniform or homogeneous entity. This is due to what might be seen as the major differences which arise in the social organization of work between different sectors of the profession. As we spoke only to partners in large law firms, there is a possibility that we obtained a one sided view of the profession, as the social organization of legal work (e.g., clientele, division of labour and types of work handled) differ markedly in these firms from those in smaller firms. However, as these large law firm lawyers specialize in securities market work, something that is less common in smaller firms, they are likely to be in a position to give us a good picture of other lawyers working in this area.

Virtually all of the large firm lawyers we spoke to, told us that they thought that lawyers in other firms like their own had very high ethical standards regarding insider trading. As one Sydney lawyer put it "ethical standards are very high in the sort of law firm that we deal with" (L56). Similarly, a Melbourne lawyer observed "ethical standards are strong in this firm and in all law firms that I have knowledge of, that is, those with which we deal in the commercial area" (L36). Another Melbourne lawyer added "in the major commerical law firms ethical standards tend to be very high". He went on to add, however, "there are smaller firms in the securities area about whom I do not have confidence" (L35). This qualification was fairly characteristic. Another Melbourne lawyer observed that "those that we deal with have the same view as we do, but there are firms prepared to take a more entrepreneurial view" (L39). This was put a little differently by a Sydney lawyer who noted that "ethical standards are high where lawyers regard the practice of law as their primary endeavour" (L57). Here he was distinguishing the more entrepreneurial lawyers found in some of the smaller firms.

It should however be noted that it has not been uncommon for takeover lawyers from the larger law firms to leave their primary commitment to the practice of law and spend their time managing corporations or involving themselves primarily in investment activities. One Perth lawyer thought that "there were lawyers who are now in control of companies who would get involved in insider trading. Most law firms however have high standards" (L13). The fact that there are lawyers who, are likely to be involved in insider trading, albeit not in the larger firms, was confirmed by another Perth lawyer when he told us

> "it depends upon the individual. Lawyers do have a training in ethical principles but there are a lot of Perth lawyers who share trade and make use of price sensitive information. The ethical standards of the legal profession in Perth are not as high as they are in Sydney or Melbourne. Here they rub hands with business and so become infused with a business ethic and not a legal ethic" (L15).

There may well be differences then between Perth and other Australian cities. One Sydney lawyer reported, finally, "I cannot recall any lawyer giving me information on insider trading" (L61).

The accounting profession has a range of firms and division of work not unlike the legal profession. The presence and influence of international firms is, however, much more pronounced in the accounting profession. We were told that standards vary but "most accountants are strongly opposed to insider trading. Those firms with strong U.S. links are particularly concerned about it" (FA17). The ethical standards "of the big auditing firms are very high" (FA40) and, indeed, they set their standards to meet the requirements of tougher overseas jurisdictions. Our accountant respondents did, however, leave us room to wonder whether the same high standards applied throughout their profession.

The Stock Exchanges as Regulators

As a further test of the effectiveness of self regulation we asked those who are close to the market for their opinions about the adequacy of the Stock Exchanges' regulation of insider trading among their members (Q52).

While some brokers spoke favourably of the performance of the Exchanges and a few said the opposite, most asked whether the regulation of insider trading was the role of the stock exchange. One of the brokers said that "they do a pretty good job" (B9). Another thought so too because "they are better than any other system" (B43). A Perth broker reflected favourably on the influence of the Exchanges when he said that they do a good job "in the sense that there is an obligation to act professionally" (B8). A less favourable view was that "they do a good job in the areas they are policing. They tend to overkill because of a lack of pragmatism. They are better than the CAC" (B52).

Negative responses were sometimes qualified. One veteran broker told us that "they used to but not now. The stock exchange inspectors have been replaced by government people. Brokers dob in their clients and other brokers to protect the industry" (B30). "Not at all" replied another - "they need proper computer programs. The government should fund the stock exchange and NCSC to develop computer programs" (B29). This reference to the lack of resources was picked up by other brokers one of whom told us that" the intention of the stock exchange is fine but the technology is wanting. There is a lack of technical capacity for enforcement" (B27). Another commentary on the regulatory process was provided by a Sydney broker who reported that

> "the stock exchange is very strict but it needs a tip off. It works in harness with the NCSC

> and CAC. The stock exchange cannot pay the salaries and does not have the equipment. Where there is a breach of the law they report it to the NCSC or the CAC" (B54).

As we saw, a number of respondents wondered whether it was the role of the stock exchange to do so. As one broker asked "do they have that power? It is not high on their priorities but they hand cases over to the NCSC" (B48). A similar view was that "rules are in place but does it see its role as regulating insider trading? Perhaps the CAC should do it" because, as this broker pointed out, "insider trading involves more than brokers so the stock exchange is limited. If it knew of cases it would act. There are some grey areas" (B31). A more definite response was that even though "the stock exchange does not have that role it would react strongly to cases of insider trading" (B28). The division of responsibility was mentioned by other brokers. As one told us "the industry does not like insider trading and it is taken very seriously but it is not the role of the stock exchange to be the regulatory body" (B10). The position was strongly put by a Melbourne broker who said that "brokers are very conscious of surveillance by the NCSC; it is more for them to do it than for the stock exchange to do it" (B32). An explanation of the role of the Exchange and of its priorities in regulation was given to us in this form

> "the stock exchange does not patrol - it wants to be told. There have been no cases [over the past 5 years]. Liquidity is a major concern of the stock exchange and rules about good conduct are also taken very seriously" (B37).

The officials of the stock exchanges were, not surprisingly, confident of the exchanges' performance. Two of those who elaborated said that the stock exchange cannot regulate in this area. As one explained, "the stock exchange is not geared up to do significant work. It is a NCSC matter - insider trading involves more directors than brokers" (R21). Another made the point about the division of responsibility by saying that "the stock exchange cannot regulate it but it will in future be able to detect it and hand it over to the regulators for prosecution" (R66). Developments in the detection process were further explained by another official who said that "improvement is possible in the detection of unusual market activity through the use of intelligent computer soft ware. There is likely to be an adoption of the sophisticated US approach" (R18).

Another official was also satisfied with the performance of the exchanges because "we do not see insider trading going on in brokers' firms. The openness of business suggests that there is no insider trading" (R12).

The responses of the financial advisers were similar to those of the brokers. None of them expressed confidence about the adequacy of the stock exchanges' regulation of insider trading but this response does not necessarily imply a criticism of the exchanges. One opinion was that even if the stock exchange could detect insider trading it "does not have the power to deal with it" (FA16) and another was that "it is not a role for the exchanges but for the NCSC and the CAC's" (FA41). It was also suggested that the exchanges do not have sufficient resources or systems to undertake this role.

As we saw earlier, there is some ground for believing that co-regulation could be developed. There seems to be a fair degree of goodwill to the agencies and, as it was pointed out more than once, the exchanges and the agencies are working to much the same goal. There is also some pressure from within the broking community for a system of co-regulation. On the debit side is the natural antipathy of Australians to regulators and it would be romantic to imagine that everybody would be happy to see the external enforcement agencies coming closer into their community. A more serious practical obstacle is that neither the exchanges nor the agencies seem to be well endowed with resources.

A system of co-regulation has the advantage of overcoming the common criticism by the industry that the agencies lack market skills. Co-regulation could allow for the harnessing of the abundant market skills within the industry and could therefore be expected to lead to an improvement in the enforcement effort. However, it is clear that neither industry bodies like the ASX or regulatory agencies such as the NCSC or CAC's can deal with insider trading regulation and law enforcement alone. Nevertheless, there is overwhelming evidence that the latter agencies must take the lead in these matters and encourage the industry bodies to provide them with more effective back-up than presently occurs.

Proposals for Law Reform.

The industry reactions to the current insider trading laws and regulatory enforcement strategies reflect a widely held belief that the existing law has failed. This series of reform proposals is based upon our assessment of the industry reaction and represents the minimum desirable change to the law. Our recommended changes relate to the Corporations Bill 1988 and are as follows:

1. The lack of any successful prosecutions in this area over many years has led to the perception that there is no effective insider trading prohibition in existence in Australia at this time. Section 128 of the Securities Industry Act and the similar draft section 1002 of the Corporations Bill 1988 is an extremely complex provision. This complexity creates almost insurmountable problems both to the industry and to those charged with its enforcement. It is our view that the provision needs to be entirely rewritten and, in so doing, simplified.

2. It is clear that the criminal law must remain the principal mechanism for the enforcement of this section and that there is little if any support for self regulation as the primary basis for law enforcement in this area. There is however strong support within the industry for the introduction of new and improved civil remedies to supplement the criminal law.

3. As it is likely that the Australian courts will continue to interpret corporate legislation narrowly it is important that various concepts within the existing (and proposed) law be clarified. This should be done both to assist corporate law enforcers and those who are likely to be subject to the law. We refer here particularly to the concept of "materiality" which we see as being in need of a clear definition. Some concern has also been expressed about tippee liability and the appropriateness of Chinese Walls as a defence.

4. On the question of the definition of materiality, we consider that it should be statutorily defined and not left to the courts to do so. There is considerable industry support for the introduction of such a statutory definition. Specifically, this definition of materiality should mean that price sensitive information is material where two reasonably informed persons regard the information as material. As we

argue in the paper there is no justification for reliance upon a percentage based price change formula of materiality and the industry regards such a formula as entirely inappropriate.

5. In regard to tippee liability we do not see there being sufficient justification for a change in the current approach, although the NCSC or ASC should be encouraged to develop guidelines to assist the industry in dealing with this sometimes difficult problem.

6. There are also procedural and evidentiary dimensions of the prosecution process which are in urgent need of reform. In particular, we are of the view that there is a very strong case for the reversal of the onus of proof once a prima facie case of insider trading has been established. Such a change in this area would be likely to fall within the guidelines for the reversal of the onus of proof laid down by the Senate Standing Committee for the Scrutiny of Bills. It also seems to us to be essential that in the revised legislation the Federal Court of Australia be given jurisdiction to hear insider trading cases.

7. At the level of prosecution, it is highly desirable that a single national prosecutorial agency be given responsibility in this area. In view of the successes of the DPP in the area of taxation fraud prosecution in recent years, we feel confident that this is the appropriate agency to undertake the prosecution of cases of insider trading.

8. In regard to penalties (s.129/s.1311) we believe that it is desirable to depart from the formula which currently applies. In particular, the upper limit for fines of $20,000 is highly unrealistic in regard to insider trading. It is clear that this figure needs to be raised at least to $100,000 for each offence. This view is widely held in all sectors of the industry. In the case of the associated penalty of five years imprisonment, we do not see that there is as urgent a need for change although other jurisdictions (such as the UK) have also seen fit to raise the maximum term of imprisonment.

9. It is clear that there is also an urgent need to introduce civil penalties, particularly the disgorgement of profits and at least double damages. Furthermore the present section 130 (s.1013 of the Bill) needs to be made more credible. There is a widespread view amongst lawyers that this section needs

to be completely rewritten to make it an effective remedy. In particular, the introduction of class or group actions to shareholders damaged by insider trading conduct, seems to us to be essential.

10. In the context of the phrase, used in the legislation, of "persons connected with a body corporate in the preceding six months" we would urge the introduction of a defence to insider trading in circumstances where all short swing profits derived during that period are returned to the corporation whose securities were traded. This defence should only be available provided the payment was made within thirty days of the profit being made.

11. In the revision of the current provisions dealing with insider trading, it is desirable to clarify the present uncertainty as to whether off-market transactions are covered by the section. They obviously should be covered and this needs to be more emphatically stated in clear and unambiguous words.

12. Similarly, it is clear that insider trading can be undertaken by a corporation. However, judicial interpretation of section 128 has read the word "person" narrowly so as only to cover natural persons. Such an interpretation, even if it is correct, would provide a major means of avoiding the insider trading prohibition. This would be contrary to the spirit of the legislation.

As detailed empirical evidence is now available to support the above propositions and as there is now a major opportunity to reform Australian corporate law, we believe that there would be considerable support from within the industry, and regulatory sectors for these proposed changes.