

FOCUS

REGULATION AND COMPLIANCE



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CORPORATE LAW REFORM THREE PACK

The Federal Government has recently issued three discussion papers on corporate law reform, covering the insider trading laws, the sanctions regime for Corporations Act breaches and ASIC infringement notices for continuous disclosure contraventions. Senior Associate Matthew McLennan and Partners John Warde and Richard Spurio highlight the main issues in each paper.

HOW DOES IT AFFECT YOU?

- The insider trading law applies to all businesses and individuals trading in 'Division 3 financial products' (which include securities and a wide range of other financial products). The proposed reforms will have a significant impact on the law and are of particular importance to directors and senior executives, issuers, members of takeover bid consortia and businesses that rely on Chinese walls.
- The review of sanctions in corporate law is relevant to directors and managers concerned about whether the law strikes the right balance between discouraging undesirable behaviour and ensuring business is willing to take sensible commercial risks.

INTRODUCTION

In the first week of March, the Federal Government issued three discussion papers on corporate law reform:

- **Insider Trading** – a paper adopting many of the changes to the law on insider trading recommended by the Corporations and Markets Advisory Committee (**CAMAC**) in November 2003 and inviting further submissions on some of those recommendations.
- **Review of Sanctions in Corporate Law** – a discussion paper addressing possible changes to the civil and criminal penalties for contraventions of the *Corporations Act 2001* (Cth) and *Australian Securities and Investments Commission Act 2001* (Cth).
- **Infringement Notices** – a paper seeking comments on the use and effectiveness of infringement notices for breaches of continuous disclosure obligations.

We examine three Federal Government discussion papers on various aspects of corporate law regulation and compliance



INSIDER TRADING

The paper on insider trading reveals which of the recommendations made by CAMAC have been adopted by the Government and identifies a number of recommendations about which the Government seeks further submissions. Submissions are due by 2 June 2007.

CHANGES ADOPTED BY THE GOVERNMENT

The Government has agreed with the majority of CAMAC's recommended changes to the insider trading law. Some of the more significant changes are discussed below.

STRENGTHEN THE REPORTING REQUIREMENTS FOR DIRECTORS

Section 205G of the Corporations Act currently requires a director of a listed company to notify the market operator (for example, the Australian Securities Exchange) of:

- any relevant interests of the director in securities of the company or a related body corporate; and
- contracts to which the director is a party or under which the director is entitled to benefit and which confer a right to call for or deliver shares in, debentures of, or interests in a managed investment scheme made available by the company or a related body corporate.

Notice must be given within 14 days of the director's appointment or any change in the director's interests.

The Government has adopted CAMAC's recommended changes to s205G. They include:

- extending the obligation to all listed entities, not just listed public companies;
- extending the obligation to senior executives as well as directors;
- extending the obligation to the one-month period after resignation; and
- reducing the disclosure period from 14 days to two business days in most cases (this is shorter than the five business days currently allowed under the ASX Listing Rules).

EXTEND THE CHINESE WALLS DEFENCE TO PROCURING

The law recognises three forms of insider trading: *dealing* (where the insider is buying or selling), *tipping* (where the insider conveys the inside information to a person who is likely to deal in or procure another person to deal in the product), and *procuring* (where the insider procures another person to deal in the product).

At the moment, the Chinese walls defence applies only to dealing. The Government has adopted CAMAC's recommendation that the defence be extended to cover procuring. This amendment will protect companies and partnerships when an employee separated from inside information by a Chinese wall procures another person to deal in a relevant product.

PERMIT TAKEOVER BID CONSORTIUM MEMBERS TO ACQUIRE FOR THE CONSORTIUM

The prohibition on dealing does not apply where the relevant information is the insider's awareness of their own intentions. This exemption would probably not apply where the inside information relates to the intentions of other members of a takeover bid consortium.

The Government has accepted CAMAC's recommendation that the exemption be amended to make it clear that a member of a prospective bid consortium can acquire securities on behalf of that consortium prior to the market becoming aware of the bid.

The member will not, however, be permitted to trade on their own behalf before the market becomes aware of the bid.

CARVE-OUT FOR GENERAL SECURITIES ISSUES

CAMAC recommended that the insider trading prohibition should not apply to a company making a general securities issue where the company is subject to a statutory disclosure regime for that issue.

This carve-out relates to situations in which the prohibition on insider trading overlaps with the fundraising disclosure obligations contained in Chapter 6D of the Corporations Act. The rationale of the change is that it removes regulatory duplication without weakening investor protection. The carve-out will not apply to investors/offerees who are in possession of inside information.

CARVE-OUT FOR TRADING UNDER NON-DISCRETIONARY PLANS

CAMAC recommended that the insider trading prohibition not apply to trading under non-discretionary plans provided the plan was entered into when the person trading was not an insider, the plan is not part of a scheme to avoid the prohibition, and the only discretion under the plan is to terminate it.

The aim of the change is to allow directors and officers to participate in non-discretionary trading plans (such as a dividend investment plan) without having to exclude themselves whenever they are exposed to inside information.

CHANGES STILL UNDER CONSIDERATION

The Government is seeking further submissions on the following CAMAC recommendations.

RESTRICT THE ON-SELLING EXEMPTION FOR UNDERWRITERS

The prohibition on dealing and procuring does not apply in respect of the on-sale of securities under an underwriting or sub-underwriting agreement. CAMAC has recommended that this exemption be confined to sales to other underwriters/sub-underwriters.

The rationale for the proposed change is that underwriters and sub-underwriters can negotiate disclosure terms between themselves but uninformed counterparties require the protection of the insider trading law.

The Government appears to be concerned about the potential effect of this change on market efficiency (eg higher underwriting risks and fees) and has called for further evidence.

REPEAL THE EXEMPTION FOR EXTERNAL ADMINISTRATORS

The prohibition on dealing and procuring does not apply in respect of transactions entered into in good faith by executors, liquidators and bankruptcy trustees. CAMAC has recommended that there be no exemption for any class of external administrator. The Government appears to be concerned about the effect of this change on the willingness and ability of external administrators to perform their role and on the potential cost of administrations.

EXERCISING OPTIONS WITH INSIDE INFORMATION

An insider who exercises an option right for physical delivery of a product covered by the insider trading law may be guilty of insider trading, even if the insider only came into possession of the inside information after entering into the option contract. CAMAC has recommended that persons who, in good faith, enter into fixed exercise-price, physical delivery, option contracts when they are not aware of inside information be entitled to exercise their physical delivery rights, even when they hold inside information.

The Government appears to be concerned about the potential advantage that this change could give an insider when deciding whether to exercise an option. It has called for further submissions.

CHANGING THE CONCEPT OF INSIDE INFORMATION

CAMAC noted that the *Financial Services Reform Act 2001* (Cth) extended the prohibition on insider trading from securities and equity-related futures products to a range of different types of financial products such as commodity products, reciprocal purchase agreements, negotiable instruments, forward rate agreements, interest rates swaps and options, foreign exchange and electricity contracts.

These products are typically traded in over-the-counter (**OTC**) markets rather than financial markets such as the Australian Securities Exchange. OTC markets do not operate under the same disclosure principles or expectations as an exchange. Nevertheless, the prohibition on insider trading still applies.

A party to an OTC transaction could be guilty of insider trading if it knew something that the counterparty did not know, even if there is no basis upon which that counterparty could expect the information to be disclosed.

In order to deal with this problem, CAMAC recommended that the insider trading prohibition apply only to confidential, price-sensitive information that must, or will have to, be generally disclosed or will be the subject of a public announcement. CAMAC also proposed that the test for when information 'is generally available' should be simplified.

These papers have been published at a time of increased scrutiny of suspected insider trading and greater activity generally by regulators, especially ASIC, armed with higher funding.

The Government's position paper expresses substantial reservations about the CAMAC proposal. The gravity of those reservations suggests that the CAMAC proposal is unlikely to be adopted in its current form. Nevertheless, in apparent recognition of the underlying problem in OTC markets, the Government has invited further submissions.

CARVE-OUTS FOR PLACEMENTS AND BUY-BACKS

The Government has also invited comment on two other CAMAC recommendations that involve changes to fundamental features of the insider trading prohibition. CAMAC recommended that the prohibition not apply to:

- issuers making placements to wholesale investors and any placees in an individual placement; and
- a company conducting a share buy-back where the company is subject to a statutory disclosure regime for that buy-back.

The rationale for these changes is that the protection of the insider trading law is not necessary in these cases because the parties to placements can negotiate additional disclosure requirements which suit them and the disclosure regime for buy-backs was adequate.

That rationale, like CAMAC's proposed changes to the concept of insider information, calls into question the proper ambit of the prohibition itself. Presumably, because these proposals raise significant questions of principle, the Government has called for further submissions.

REVIEW OF SANCTIONS IN CORPORATE LAW AND INFRINGEMENT NOTICES

The Government's paper, Review of Sanctions in Corporate Law, invites comments on the effect of the current system of sanctions on commercial decision-making. The deadline for written submissions is 1 June 2007.

The paper considers two broad approaches to possible reform:

- re-examine the principles guiding the use of different types of sanctions; and
- refine the underlying offence provisions to identify more clearly the circumstances in which a sanction may be imposed.

CHANGE THE SANCTIONS

There are three main categories of sanction: criminal, civil and administrative. At present, criminal sanctions are the default option in the Corporations Act. The paper suggests that this approach should be changed so that criminal sanctions are limited to cases involving serious wrongdoing.

The paper notes that civil sanctions were introduced in order to provide regulators with greater flexibility in enforcing the law. It invites submissions on whether the range of contraventions subject to civil sanctions should be increased and whether those sanctions themselves should be made more severe.

Administrative sanctions are suitable for minor contraventions. The paper notes that breaches of low-level record-keeping and reporting provisions in corporate law may be better dealt with by administrative sanctions than the current criminal penalties.



An existing example of the use of administrative sanctions is the continuous disclosure **infringement notices** addressed in the third paper circulated by the Government. The Corporations Act was amended in 2004 to give ASIC the power to issue infringement notices for breaches of the continuous disclosure provisions. The stated purpose of the Government's paper is to review those provisions in light of two years of operation.

Under the current law, where ASIC considers that an entity has breached its continuous disclosure obligations, ASIC may serve an infringement notice on that entity demanding payment, without admissions, of \$33,000, \$66,000 or \$100,000 (depending on the size of the offender). If the entity complies with an infringement notice and pays the amount sought,

it will not be subject to further civil penalty or criminal proceedings. The entity may, however, be subject to civil claims by persons alleging that they have suffered loss as a result of a non-disclosure. The paper notes that infringement notices have been issued and complied with on only five occasions to date. Submissions on this paper are also due on 1 June 2007.

CHANGE THE RULES

The principal concern here appears to be how to strike a balance between discouraging undesirable behaviour and ensuring business is willing to take sensible commercial risks.

Of the possible changes explored in the paper, the most significant would be the introduction of a general defence for directors where they act in good faith, within the scope of the company's business, and for the company's benefit.

This defence could be extended to insolvent trading cases. It might be complemented by an easing of the test that directors must satisfy in order to demonstrate that they acted reasonably in relying on advice or information provided to them by others.

The Government invites submissions on these and other possible changes to the Corporations Act but does not provide any clear indication as to whether it is likely to adopt them.

A DYNAMIC ENVIRONMENT

These papers have been published at a time of increased scrutiny of suspected insider trading and greater activity generally by regulators, especially ASIC, armed with higher funding.

The clarification of the Government's position on the CAMAC recommendations regarding insider trading is welcome. There remain, however, a number of CAMAC recommendations whose eventual fate is yet to be determined. The very broad scope of the current insider trading regime remains a legitimate concern to business and the general community. Any proposed legislative changes that emanate from the Government's review will be closely watched.

The invitation to comment on changes to the sanctions for corporate wrongdoing is an opportunity to participate in a debate about what approach to sanctions business and the general community consider should apply to contraventions of varying levels of seriousness.



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