INSIDER TRADING - CHINESE WALLS FOR BANKERS

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Before I look at the proposals in the Green Paper I would like to make a few observations which are relevant in the context of the proposals which have been made by Professor Anisman. As many of you would be aware from recent press publicity the Commission is presently interested in the laws on insider trading, the effectiveness of those laws and their enforcement. In this regard the Commission is committed to doing something to making the laws work.

Part of the Commission's mandate is having the responsibility and administration of the securities legislation and the regulation of the securities industry. With the support of the Ministerial Council it instituted a working party in 1983 to examine the existing laws.

A discussion paper was prepared by Professor Philip Anisman. The paper included a draft set of proposals for reform of the existing framework which is set out in s.128 of the Securities Industry Act. The paper was released to the public last year. I would like to emphasise at this stage that the proposals in the paper do not necessarily represent the views of the Commission. The Commission has yet to formulate detailed recommendations and I will say more on that towards the end.

One of the primary purposes in exposure of the paper was to promote discussion and exchange of ideas between the Commission and participants in the securities industry, such as many of you here, with a view to assisting the Commission in formulating recommendations for legislative reform. The response to the paper which proposes some quite radical changes to the existing laws and which may have a dramatic impact on the manner in which market participants conduct their operations has been disappointing.

Some of the major proposals include widening the definition of "insiders" and "inside information" and, perhaps significantly, reversing the onus of proof on an accused in criminal proceedings. However, out of the twelve formal submissions that were received some valuable contributions have in fact been made.

What has been equally surprising is that out of those twelve submissions made, only one of them mentioned the proposals put forward by Professor Anisman on Chinese Walls. This is particularly perplexing first, in view of the interest which has been generated in recent times on Chinese Walls and secondly, in light of the novelty of one aspect of the Chinese Wall defence which he has proposed.

Much of what has been said recently on Chinese Walls has arisen from overseas experience although Australia has had its own share of conflict situations in recent times. Apart from the interest and moves made by regulators and self regulatory bodies in overseas countries I have noted that in Canada in particular even the courts have shown an increased willingness to extend fiduciary obligations in situations involving duties of fairness and proper use of confidential information.

Before discussing Anisman's proposal I shall make a few quick observations. It has been widely recognised that, whilst development of the market has given rise to the need for financial intermediaries to provide multiple services which, in turn, may have increased the scope for the improper use of inside and confidential information, there is no perfect solution to satisfactorily addressing conflict situations.

A problem for the regulator is to ensure that in achieving efficiency and integrity in the markets and those operating in the markets that conflicts of interest are properly handled. It is a matter of developing suitable rules to ensure that on the one hand confidential price sensitive information is not improperly used in contravention of the laws against insider trading within an organization which provides a range of services whilst on the other hand ensuring that the interests of all clients and members of the organization are adequately protected and, importantly, that their expectations are met.

To date the Commission's attention has predominantly focused upon the effectiveness of arrangements amongst brokers which are members of the Australian Stock Exchanges. In particular, following the unfixing of brokerage rates and the admission of corporate members to the stock exchanges, the exchanges amended their business rules to include rules relating to conflict situations within their member organizations. It was essential that potential conflict situations were more closely examined and monitored. Accordingly, amendments to the business rules were allowed which provided for formalised procedures to be adopted by member organizations to deal with conflicts. This possibly represented the first step which was taken by the Commission in the recognition of effective and acceptable ways of erecting Chinese Walls.

The Commission constantly and closely monitors the situation through requests for reports from the stock exchanges on their monitoring of conflict situations within their member

organizations. However, it has become apparent that organizations such as banks, merchant banks, life insurance companies and the like are also rapidly diversifying their operations through the expansion of services being provided including establishing links between different types of intermediaries together with new types of financial products which they are marketing.

In addition, senior executives are taking positions on boards of companies which are or may become clients of the financial intermediaries. In this regard it is probably fair to say the conflict situations in the area of the securities industry will become more acute with mounting pressure to provide competitive services and it may be an appropriate time for the regulators to take a more active role in monitoring ways organizations outside the jurisdiction of the Australian Stock Exchanges are handling their conflict situations.

I am aware that a number of banks and merchant banks already have in place a range of Chinese Walls to cope with conflicts. In particular, some have adopted the types of rules to which the legal profession has been subject for some time.

Another which has recently come to my attention and has been described as the perfect Chinese Wall involves a bank with separate banking and corporate advisory departments. Directors of the bank are also directors of a wholly owned company which deals in investments. The directors are prohibited from participating in board meetings where, for example, one of the departments is acting or may act for a potential offeror or target company. Not only do the directors not know the identity of the client, nor do they receive board minutes relating to discussions on such matters. These directors are also dealers in the securities market.

Whilst in an insider trading context it may be entirely proper for the directors to not become privy to information that they might otherwise use to obtain an unfair advantage over other market participants in their dealer capacities, some interesting questions are raised as to what other duties they might owe, not only to clients of the company but also to the company's members.

If a director did learn the identity of a client and a nature of the conflict, one would expect disclosure to be made or that the relevant securities be placed on some sort of restricted list so far as their dealing activities were concerned. The difficulty with this is that irrespective of an argument that stop lists themselves indicate that something may be about to happen, clients of the director acting in his dealing capacity may unwittingly be denied the advantage of any profitable moves that the dealer may have made in the shares of the issuing company had he not known the information and in this regard I refer to the case that Robert has already referred to, the Standard Investments case.

Whilst no Chinese Wall defence was actually argued in that case it illustrates the potential trap. There is no guarantee that an organization which has effective arrangements in place to defend a criminal action against insider trading will have a defensible position at common law for a breach of a fiduciary obligation owed to a client or for a breach of a duty owed as a director.

Before looking at Anisman's proposals I would like to suggest a few measures which from the regulators' viewpoint may be appropriate in handling conflict situations. First, it is necessary to ensure the proper education of officers and employees of a financial organization so that they fully understand and appreciate the conflict type situation. Second, that disclosure to clients of the existence of arrangements to ensure that inside information is not used in contravention of statutory prohibitions are in place and the fact that such arrangements may prevent the use of information possessed by certain members of the organization in their clients' interest. Third, that disclosure of any actual conflict to a client be made if and when it arises. Fourth, that encouragement be given to clients that inside information be disseminated at the earliest opportunity. Fifth, that there are proper enforcement and monitoring systems within the organization itself and that adequate supervisory roles are undertaken by the self regulatory bodies. And finally, that there are adequate resources for effective enforcement of the laws by the Commission.

From looking at the nature of Chinese Walls currently in place two things would clearly emerge. First, that it may not be possible to devise a uniform code of acceptable conduct which is appropriate to every organization having regard to their vastly differing structures and sizes and perhaps more importantly that the effectiveness of any regime will depend upon the willingness of the individuals themselves to ultimately resolve their own conflicts.

In the final analysis it is the individuals who will have to establish a defensible position both insofar as insider trading is concerned and also other legal and ethical obligations that they may have to their clients.

Turning now to the Green Paper, Professor Anisman has advocated retention of the existing defences in sub-ss.128(7) and (9) of the Securities Industry legislation. He has suggested that apart from fixing up some minor anomalies in those provisions that the Commission be charged with the task of specifying minimum standards for intermediaries which have prophylactic arrangements. And secondly, that strict adoption of a Chinese Wall will not give rise to any breach of a fiduciary duty if fulfilment of the duty would have made the defence unavailable.

With regard to the latter, Professor Anisman has proposed making the duty of an organization to not disclose inside information override any common law obligation. The obligation would however

only be subordinated where fulfilment of the duty would have meant that the fiduciary could not rely upon the statutory defence. In other words, arrangements must be in place to prevent the flow of confidential price sensitive information over the wall between the departments. Under the proposal what constitutes a suitable arrangement would ultimately be left to the Commission to determine.

In theory the proposal would overcome a problem which has been alluded to earlier and which was highlight by the Standard Investments case. However, given that the effectiveness of a Chinese Wall has never been litigated it is difficult to anticipate how the courts might react to such a defence being mounted in a civil action. Professor Anisman's proposals may have implications for equitable rights and remedies available to clients of an organization which has been retained to act in the clients' best interests. Regardless of what minimum standards were set to deal with conflicts I suggest that a heavy onus would rest upon a defendant to establish the effectiveness of the wall.

As I mentioned at the outset, the proposals in the paper do not represent the Commission's views at this stage but were simply released to promote and encourage discussion on the insider trading laws. At this stage the proposals are being looked at together with the submissions that have been made. They are also being looked at in conjunction with the perceived defects in the existing laws and the problems encountered within the Commission and by the Commission's delegates in their enforcement.

When the review has been completed recommendations will be made to the Ministerial Council, possibly for changes to be made. However, given the Commission's concern at the objections which have been taken to Anisman's proposals, it is probably likely that the Commission will consult with the industry prior to any final recommendations going to the Ministerial Council.

I would like to emphasise that if people wish to make any submissions or comments from now on then they are free to do so notwithstanding that the closing date for submissions has passed.