INSIDER TRADING - CHINESE WALLS FOR BANKERS

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You may well ask what a litigation lawyer is doing sitting with this illustrious group talking on Insider Trading and Chinese Walls. And the answer is that I have absolutely no idea, but if I am to hazard a guess it may be that in this age of aggressive and sometimes unscrupulous takeover litigation merchants, the focus on insider trading will be increasingly litigation oriented. I have been assured of two things this afternoon. The first is that this is the hot topic of the conference and the second is that many of you have come here today armed with questions from the "too hard basket" in the office expecting answers to them. And on the basis of those assurances I propose to speak at some length and take up what available question time there otherwise would have been.

The essential ingredients of insider trading are well known to all of us, simply stated and found in s.128 of the Code and I don't propose to repeat them. There are many different categories of "insider" and without giving an exhaustive list they include the directors, officers and employees of a corporation, substantial shareholders (using the term as defined in the Companies Code), persons in a business relationship with a corporation, persons in a professional relationship with a corporation (for example accountants, bankers and lawyers), tippees and offerors.

Richard Youard, I believe, will later today comment on differences between "insiders" under our Code and the situation in the United Kingdom, but let me dwell briefly on two of those categories which pose some difficulties for us. The first is that of the tippee. Under s.128 as you no doubt all know the tippee is only caught if that person had at the time he received information a business relationship or an arrangement with a primary insider to pass on information of the kind that s.128 is concerned with. That is all very well but the problems arise when the tippee becomes a tipper and in that situation the provisions of sub-ss.(3) and (4) are probably not satisfied. The situation I understand is different in the United Kingdom and I will listen with interest to what Richard has to tell us about that.

The second category that poses a problem is that of the intending offeror. Take a situation where a person has decided to announce a takeover bid and prior to the announcement uses a number of associates to acquire shares in the proposed target, complying with the provisions of the takeover legislation. On the face of it that person is not at that time an insider under s.128. And that, having regard to the rationale of s.128 I think is a proper and fair result. But insiders of the intending offeror clearly ought to be treated as insiders for the purpose of s.128. Query whether they are.

The Code recognises what we call Chinese Walls in sub-s.(7) and that term of course is nothing more than a description of an arrangement which in simple terms prevents the flow of information from one department to another so a person accused of insider trading can prove in fact (and I will come to onus of proof in a moment) that he or she did not have relevant knowledge at the relevant time.

How far one has to go to establish a Chinese Wall is yet to be determined. Many merchant banks and broking houses these days and other financial institutions have physical separations of their corporate advisory department and their securities and investment department and for good reason. That is the beginning of the Chinese Wall. That separation need not be more than a physical separation of offices on the same floor but it may be a physical separation of floors or a separation of departments between buildings. The extent of the physical separation is largely immaterial because what is necessary, and it comes down to a matter of evidence, is proving that the separation in effect had the result of preventing the information passing from one department to the other, so whether the separation is one on the same floor or between buildings is inconclusive.

The arrangements therefore have to go further because in fact what has to be proved is a negative. Let me explain what I mean by that. To come within sub-s.(7) to establish the Chinese Walls we have heard so much about, the person concerned has to prove that he was not in receipt of the information at the relevant time and this is not, in my opinion, proved by saying "I made a decision based on certain information". That does not prove the negative. So one has to go further than proving a mere physical separation. A lot of information these days is stored on computer so one essential ingredient of the Chinese Wall is an access code or codes and fail-safe systems within the computer to both restrict access to sensitive information and to prove who had access and who used that access at particular critical times.

A third ingredient of the Chinese Wall is the clean desk policy. This has come from a trend which started in America roughly a decade ago when the multi-nationals moved away from patent protection and moved towards relying upon the confidentiality of their information. Let me give you an example of how this in fact has operated in practice.

The first Anton Pillar Order granted by a single judge in the Victorian Supreme Court was granted to Rohm and Haas in June of 1982. It was granted in circumstances where the American corporation claimed that certain monomers were its exclusive property, monomers used in the manufacture of paint, and it went to the Court and sought to establish that it is impossible to reverse engineer these monomers and that because of its sophisticated clean desk policy the Victorian company allegedly manufacturing the monomers must have come by the information in an unauthorised manner and in breach of its proprietary rights in that intellectual property. The Anton Pillar Order was granted and in fact to obtain that order Rohm and Haas filed several thousand pages of affidavit material.

One can ask the question rhetorically "What would be required of a merchant bank, what would be required of a major stockbroker, to prove on affidavit material existence of a Chinese Wall (that is to prove the negative) having regard to the hundreds of thousands of transactions they are involved in?" It may well be impossible for them to prove the existence of an effective Chinese Wall.

The onus of course of proving the existence of a Chinese Wall is on the person seeking to rely upon it as a defence, for want of a better term, to an allegation of insider trading. That is not clear from s.128 sub-s.(7) but the New South Wales Court of Appeal accepted that in the Hooker Investments Case [1] and I think that is probably now established law in this country. The contravention of s.128 of course involves both criminal and civil penalties and that raises hypothetically an interesting situation, namely that a corporation could fail to successfully prove the existence of a Chinese Wall and so be liable in damages in civil proceedings and a director of that corporation could on the same evidence go so far as to raise a reasonable doubt and so in a criminal prosecution succeed before a jury.

The Chinese Wall defence however is not available to unincorporated associations including professional partnerships although there can be no good reason for this limitation on its application. To suggest that at common law the attribution of knowledge between partners necessarily means that for the purposes of the Securities Industry Code each member of the partnership ought to be regarded as being possessed of the knowledge of each other partner is a fiction which fails to recognise the fundamental changes that have occurred in the practice of commercial law in recent years particularly in the takeover area and the trend towards amalgamation of partnerships which now cross state and national boundaries is going to exacerbate this problem.

The traditional conflicts of interest which we grappled with in the 1970s are now largely overshadowed by conflicts of duty and duty. Let me give you an example of what I mean by that. Last year my firm in conjunction with Blake and Riggall acted for the

Bell Group of companies in the BHP takeover and in conjunction with Freehill Hollingdale and Page acted for Equiticorp Tasman in the ACI takeover battle. At a critical time in the BHP battle, Equiticorp, unknown to myself and my partners, purchased a strategic 5% stake in BHP. I might say that at that time one partner was acting in the BHP matter and another partner in the ACI matter and there was no flow of information between the two of us.

As soon as the purchase by ET become public we were faced with a situation where some saw a potential conflict and we considered it necessary to act to stop that conflict becoming an actual conflict. A decision was taken to immediately cease acting in the ACI matter. At the time we were not privy to information confidential to ET which was inimical to Bell's interests and we saw no conflict of duty in continuing to act for Bell. The fact that legal practitioners do not have the protection afforded by Chinese Walls solely because they cannot incorporate is to me another compelling reason why practitioners ought to be permitted to incorporate and the failure of the legislatures to recognise this need, particularly in the face of the sort of penalties we find in s.129, is to say the least difficult to understand.

Whilst our superior courts have not yet had to come to grips with the attribution of knowledge between directors of a corporation that issue has arisen overseas and let me refer briefly to a decision of the Court of Appeal in Canada in the case of Standard Investments Limited et al v. The Canadian Imperial Bank of Commerce [2]. The facts of that case can be briefly stated. In the early 1970s Rueben Cohen, a Canadian lawyer, and his long term friend and business associate Leonard Ellen, a Quebec stockbroker, decided to endeavour to acquire a controlling interest in the Crown Trust Company. By the end of 1971 they had acquired 52,000 shares in that company through their vehicle Standard Investments Limited.

They decided that to succeed in their efforts they required the financial assistance, advice and support of the defendant. The defendant was the banker to the target. In April of 1972 they discussed their proposal with Page Wadsworth the then president of the defendant bank and he did nothing to discourage them from their plans. Unknown to him at that time the chairman of the bank, Neil McKinnon, had at the request of a fellow director agreed that the bank would itself take a position in the target company and would acquire more shares to thwart the plaintiff's proposal and any other threatened takeover.

The upshot of that was that the defendant bank acquired shares up to 10% and another of its customers acquired 44% of the target. Some seven years later the bank and its customer sold the two parcels of shares to a third party which acquired what was an effective controlling interest in the target.

Cohen and his business partner lost at first instance in an action for damages for breach of fiduciary obligations but

succeeded on appeal. The Court of Appeal held that the giving of confidential information to the bank and the plaintiff's reliance on the bank's advice created a fiduciary relationship. That comes as no surprise to us. It also held that the bank was in breach of its duty by failing to disclose its conflict of interest and by failing to refuse to advise the plaintiffs. Again that comes as no surprise to use. And it was also in breach in continuing to finance the plaintiff's acquisition without disclosing its conflict of interest. All of this in the face of the trial judge's finding, which was not upset on appeal, that Wadsworth the president had acted in good faith and his conduct was beyond reproach.

I mention the case because what is interesting are the observations of Acting Justice Goodman who delivered the judgment of the Court of Appeal. This is of particular interest in relation to the attribution of knowledge between directors of a corporation. What he said was this:

> "It is my opinion that as a matter of law a corporation may have more than one directing mind operating within the same field of operations but I am of the further view that where such a state of affairs exists a corporation cannot be found in law to have a split personality so that it can rely on the lack of knowledge on the part of one of its directing minds of the acts, intention and knowledge of the other directing mind operating in the same sphere to protect it from the liability for the actions of the first directing mind or the combined activities of both directing minds. At least in civil cases where the element of mens rea is not applicable when there are two or more directing minds operating within the same field assigned to both of them, the knowledge, intention and acts of each become together the total knowledge, intention and acts of the corporation which they represent."

Notwithstanding the provisions of s.128 sub-s.(7) of our Code it would surprise me if our courts did not come to the same decision faced with the same factual situation but it does not necessarily follow that the bank or its officers would in those circumstances be guilty of insider trading. I am told by Phillip that there will not be a question time.

Let me conclude quickly. Many of you will have created what you regard as effective Chinese Walls in your organizations but it is inevitable that cracks will develop. It is important to address the problems which arise when that occurs. It should be understood at the outset that unlike the little boy who put his finger in the hole in the dyke and stopped the flow, once a crack appears in a Chinese Wall it cannot be effectively patched up in relation to any existing transaction and the reason is obvious. The whole essence of the Chinese Wall is the proof of lack of knowledge and once the crack has appeared it is impossible to prove the negative. In a dealing situation that means you cannot

continue to deal and in a situation where you are faced with a conflict of interest you must cease acting for both parties.

Let me illustrate what I mean by that principle by this example. In the ET situation I mentioned earlier, had ET informed my firm prior to the purchase of the strategic parcel in BHP that it was intending to purchase that parcel we would have had to cease immediately acting for ET because there was a classic conflict of interest, their position being inimical to the interest of Bell. Yet at the same we could not have continued to act for Bell because there is the classic conflict of duty and duty: the duty to keep the confidential information confidential to ET and the duty to use that information in the interests of Bell.

Moreover, in that situation, we would not have been able to acquaint either client with a reason why we could not continue to act. Hardly the stuff of which harmonious solicitor/client relationships are made.

In conclusion, a number of commentators have suggested that there is a need to strengthen the Code to give it some teeth to put an end to insider trading which is regarded as being widespread, a cry which echoes the call in the late 1970s for a strengthening of the Tax Act and the then regarded as impotent s.260 in the face of sophisticated tax avoidance schemes. I can't help but think that were it not for the problems of proof and evidence and manpower and financial resources the Commission faces, and Elspeth Arnold will address those in a moment, the existing legislation will prove to be effective. The Commission is now moving away from its focus on stockbrokers to bigger fish and maybe those fish are here today.

Finally, let me leave you with this thought. The small shareholder has to date gone largely unprotected: so too the shareholder who has sold his shares in a target prior to the announcement of a bid at an undervalue. If you regard insider trading as inherently unfair in my opinion a compelling case can be made out for class actions in the circumstances I have just described. I have no doubt that as the end of the decade approaches the lid of the pandora's box on insider trading will continue to open. Today we can only speculate about what it will reveal.

Footnotes

[1] Hooker Investments Pty. Ltd. v. Baring Bros. Halkerston & Partners Securities Ltd. (1986) 4 A.C.L.C. 243.

[2] 52 O.R. 473.