Continuous Disclosure, Insider Trading and Conflicts

UNSW Corporations Law and Director's Duties Seminar

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Continuous Disclosure

1 Takeovers – Approaches and Disclosure

1.1 Listing Rule 3.1

The first topic of discussion today is the application of the continuous disclosure requirements of the ASX Listing Rules in the context of bid proposals. Although not a director's duty, it is however an important disclosure issue for the board of any listed company which is subject to a bid proposal.

Further, it now seems clear that a failure by a listed company to comply with its continuous disclosure requirements may result in a breach of duty by the directors of the company. In the James Hardie decision,[1] the James Hardie directors were found to have breached their duty to act with the required degree of care and diligence by approving a draft ASX announcement containing false or misleading statements.

Under ASX Listing Rule 3.1, a listed company must immediately disclose to ASX any information it becomes aware of that a reasonable person would expect to have a material effect on the price or value of the company's securities.[2]

A company becomes aware of information if a director or executive officer (i.e. a person taking part in the management of the entity) has, or ought reasonably to have come into possession of the information in the course of the performance of their duties as a director or executive officer of the company.[3] Information can include opinions (ie. of the board) as to matters including the solvency of a company[4] and the legal effect of agreements entered into by a company[5]. However, a disclosable obligation only arises in relation to opinions actually held. It does not require the disclosure of opinions that should have been held or could have been held, but were not.

Under the *Corporations Act 2001 (Cth)* (the Act), a reasonable person is taken to expect information to have a material effect on the price or value of securities if it would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell the securities.[6] This does not distinguish between sophisticated or wholesale investors and retail investors, large and small investors. Rather, 'persons who commonly invest in securities' are a hypothetical class of reasonable, not irrational or idiosyncratic persons.[7]

1.2 Listing Rule 3.1A

Listing Rule 3.1A contains an exception to the disclosure requirement in Listing Rule 3.1. It applies while each of the following three requirements are satisfied:

(a) one or more of the following applies:

(i) it would be a breach of a law to disclose the information;

(ii) the information concerns an incomplete proposal or negotiation;

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[1] *Australian Securities and Investments Commission v Macdonald (No11)* [2009] NSWSC 287.

[2] *ASX Listing Rule 3.1.*

[3] *ASX Listing Rules - Chapter 19.*

[4] *Grant-Taylor v Babcock & Brown (in liq) (2015) 322 ALR 723.*

[5] *Australian Securities and Investments Commission v Fortescue Metals Group Ltd (No 5) (2009) 264 ALR 201.*

[6] *Section 677 Corporations Act 2001 (Cth).*

[7] *Grant-Taylor v Babcock & Brown Ltd (in liq) (2016) 330 ALR642, 663 [115]-[116]; 665 [128].*

(iii) the information comprises matters of supposition or is insufficiently definite to warrant disclosure;

(iv) the information is generated for internal management purposes of the company; or

(v) the information is a trade secret.

(b) the information is confidential and ASX has not formed a view that the information has ceased to be confidential; and

(c) a reasonable person would not expect the information to be disclosed.

A proposed bid for a listed company is information which would be expected to have a material effect on the value of the target's securities and therefore require disclosure under Listing Rule 3.1. However, the requirement to disclose that information will not apply where the information is confidential and relates to an incomplete proposal or negotiation. This exception will continue to apply to the bid proposal for so long as it remains incomplete and confidential. However, there are two important considerations that apply to this exception.

Confidentiality

First, the exception will cease to apply if ASX forms the view that confidentiality has been lost in relation to the information. ASX has stated that loss of confidentiality may be demonstrated by:

(d) otherwise unexplained movements in a company's share price or changes in trading volumes; or

(e) information in media or analysts' reports- especially where references to a company or its proposals come from a credible source and are reasonably specific or detailed.

ASX will take into account the extent to which confidentiality has been lost. If a proposed transaction is revealed, ASX may ask the entity only to confirm to the market that negotiations are taking place, and not require disclosure of the details of the transaction which remain confidential.[8]

False market in securities

Second, the carve-out for confidential and incomplete proposals and Listing Rule 3.1A will not apply if ASX considers that there is, or is likely to be a false market in the company's securities and asks the company to give it information to correct or prevent the false market.[9] In this case, the entity must give ASX the information needed to correct or prevent the false market even if the information falls within the carve-out for Listing Rule 3.1 because it is incomplete and confidential.

ASX will consider that there is, or there is likely to be a false market in a company's securities in the following circumstances:

(f) the company has information that it has not released to the market because, for example the carve-out for Listing Rule 3.1A applies;

(g) there is reasonably specific rumour or media comment in relation to a transaction involving the company that has not been confirmed or clarified by an announcement by the company to the market; and

[8] *ASX Guidance Note 8.*

[9] *ASX Listing Rule 3.1B.*

(h) there is evidence that the rumour or media comment, is having, or ASX forms the view that the rumour or media comment is likely to have, an impact on the price of the company's securities.

ASX will take the circumstances of each case into account when deciding whether there is, or is likely to be, a false market in the entity's securities. It will usually consult with the entity in question to gain a full understanding of the matter before it decides that a false market exists, or is likely to exist, in relation to an entity's securities.

1.3 Disclosable or not?

In this context, there are two case studies worthy of mention:

Promina

In March 2007, Promina Group Limited (**Promina**) elected to pay $100,000 to ASIC after being issued with an infringement notice on 21 February 2007[10] which alleged that Promina had failed to comply with its continuous disclosure requirements in relation to the proposal by Suncorp-Metway Limited (**Suncorp**) to acquire Promina.

The relevant facts[11] were:

- Promina first became aware of the Suncorp proposal at approximately 6 pm on 10 October 2006.
- Shortly before noon on 11 October 2006, Promina became aware of press speculation about a potential acquisition of Promina.
- Promina discussed the matter with ASX and, after consultation with Suncorp and its advisers, was of the view that it was not required to make an announcement, as the proposal remained incomplete and confidential.
- On 11 October 2006, Promina's share price increased from an opening price of $6.10 to a high of $6.82, an increase of 11.8%. Significantly heavier trading volumes accompanied this increase.
- Promina's board met to consider the Suncorp proposal on the evening of 11 October 2006. Later that evening Promina received the first written acknowledgement of the terms of the proposal. Discussions in relation to the proposal continued between Promina and Suncorp through the course of the night.
- Promina lodged an announcement in respect of the proposal at approximately 7 am on 12 October 2006. That announcement was released to the market at approximately 8.29 am.
- ASIC's position was that Promina should have made this announcement on 11 October 2006, following press speculation on the proposal around noon that day.

Rio Tinto

In June 2008, Rio Tinto Limited (**Rio Tinto**) elected to pay $100,000 to ASIC after being issued with an infringement notice on 10 April 2008[12] which alleged that Rio Tinto had failed

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[10] *Compliance with the notice was not an admission of guilt or liability and Promina was not regarded as having contravened the Corporations Act.*

[11] *Based on publicly available information.*

[12] *Compliance with the notice was not an admission of guilt or liability and Rio Tinto was not regarded as having contravened the Corporations Act.*

to comply with its continuous disclosure requirements in relation to a proposed acquisition of Alcan Inc. (**Alcan**).

The relevant facts[13] were:

- Rio Tinto had been engaged in confidential discussions with Alcan in relation a merger for some time. Rio Tinto understood that Alcan was in discussions with a number of other parties whose merger proposals were being considered by Alcan.
- Rio Tinto was advised that it was the preferred bidder at approximately 8.07 am on 12 July 2007, subject to final negotiation and agreement of transaction documents. At this stage, Rio Tinto was of the view that there was no requirement for an announcement or a trading halt.
- At approximately 2.30pm on 12 July 2007, Dow Jones Newswires reported that Rio Tinto was close to finalising a deal with Alcan at a cash price of $100 per share- the actual price was US$101. Articles were also published by Reuters speculating that Rio Tinto was close to finalising a deal with Alcan.
- After discussions with ASX, Rio Tinto was of the view that it was not required to make an announcement in relation to the transaction. In particular, Rio Tinto was of the view that confidentiality had not been lost because:
    - media reports were only general in nature and some continued to refer to at least one other party as a bidder; and
    - there had been no material increase in the price of Rio Tinto shares or any abnormal trading volumes.
- Between 2.30 pm and 3.41 pm on 12 July 2007, 725,624 Rio Tinto shares were traded (representing 37.6% of the volume of the day's trading) and the value of the shares traded in that period was $64,899,964 (representing 35.3% of the value of the day's trading).
- Rio Tinto initiated a trading halt at approximately 3.40 pm on 12 July 2007. The trading halt was applied at 3.42 pm.
- At approximately 4 pm on 12 July 2007, Rio Tinto announced details of its offer for Alcan.
- ASIC was of the view that confidentiality was lost at 2.30pm when the Dow Jones Newwires reported that Rio Tinto was close to finalising a deal with Alcan.

It's fair to say the outcome of these cases was to create some confusion and uncertainty in the market in relation to the disclosure of confidential bid discussions and proposals. This confusion and uncertainty culminated in the **David Jones** debacle in 2012.

The relevant background is:[14]

- On 28 May 2012, David Jones Limited received an unsolicited letter from a UK firm, EB Private Equity, containing a 'highly conditional, uncertain and incomplete' expression of interest. At this point, David Jones took the approach that it could rely on the disclosure exception available to it under listing rule 3.1A and the proposal was confidential and incomplete.

[13] *Based on publicly available information.*

[14] *Based on publicly available information.*

- On 28 June 2012, David Jones received a further letter enclosing an offer which included conditions, and did not include details on the bidder's financial capacity, management or other terms of the acquisition. Again, David Jones' position was that the offer was confidential 'highly conditional, incomplete and uncertain'.
- On 29 June 2012, David Jones became aware that information about the EB Private Equity's approach was likely to be known to third parties outside the company, including two financial market participants and one property market participant.
- At the opening of trading on 29 June 2012, David Jones made an announcement saying that it had received 'an unsolicited letter from non-incorporated UK entity about which no usual public information is available, indicating its interest in making an offer for the company'.
- Later that day, after David Jones became aware that international media outlets had details of the offer and were publishing them online, David Jones released a second announcement to the ASX. The second announcement named EB Private Equity as the potential bidder, referred to the proposal as a A$1.650 million proposal for 100% of the company. It went on to state that 'no details of EB Private Equity's financial capacity, its management, or any of the other terms of the residual equity have been made available. No further details of the proposal have been provided'.

The share price of David Jones went on a roller coaster ride following the announcements. EB Private Equity withdrew its bid following the announcements, although by all accounts there looked to be no substance to EB Private Equity or its proposed bid.

In 2013, ASX updated it Guidance Note on continuous disclosure. Amongst other things, the changes were intended to clarify the operation of Listing Rule 3.1 in relation to disclosure of an incomplete and confidential takeover proposals. The changes sought to de-emphasise the importance of the 'reasonable person' test under Listing Rule 3.1A. ASX was of the view that companies were taking a very broad view of this test, which resulted in the premature disclosure of information (eg. David Jones), or companies refraining from disclosing negative information. ASX confirmed that the reasonable person test would not require disclosure of a takeover offer which was confidential and incomplete.

Despite the changes, there still seems to be some uncertainty in the market around the continuous disclosure rules in the context of takeover approaches.

So, what should a company do if it enters into confidential discussions for a potential takeover? The key message to come out of the ASX guidance and these cases is that the company needs to constantly monitor relevant press coverage, its share price and trading volumes. It should also have a "leak" strategy and a draft announcement or request for a trading halt ready to go in the event that confidentiality is lost in relation to the takeover proposal. In this regard, trading halts have been specifically designed to protect listed entities from premature disclosure where a more detailed announcement is imminent.

Other ways that companies have sought to manage their disclosure obligations in the face of takeover discussions include:

- **Post-deal due diligence conditions**: There have been an increasing number of Australian transactions that have included a due diligence condition, which enables the bidder to conduct due diligence after formal agreements have been executed and announced. Adverse findings in the due diligence might enable a bidder to terminate

the transaction (see Toll (Japan Post), Graincorp (Archer Daniels), Gloucester Coal (Yanzhou Coal), AXA APH (AMP) and Oz Minerals (China Min-Metals);

- **Process Agreements**: where parties announce a transaction, before they have completed due diligence or agreed on transaction documents (see St.George (Westpac), Ludowici (FL Smidth & Co) and Lion Nathan (Kirin); and
- **Pre-bid conditions**: where a bidder will announce an intention to make a takeover on certain terms, subject to completion of due diligence (see MSF Sugar (Mitr Phol Sugar) and Realestate.com.au).

2 Earning Guidance and Earnings Surprises

2.1 Earnings Guidance

A listed entity may provide earnings guidance to the market on the basis that such periodic information is helpful in the assessment of the value of their securities. Such disclosure is not a specific requirement of Listing Rule 3.1, except where its earnings for a reporting period will be materially different to market expectations, as discussed further below with reference to 'Earnings Surprises'. An entity is not required to report earnings to the market until the due date specified in Chapter 4 of the Listing Rules.

ASX Guidance Note 8 discusses the issues surrounding providing earnings guidance and highlights that[15]:

(a) Earnings guidance is a forward looking statement, and as such the entity must have a reasonable basis in fact for providing such guidance, otherwise the guidance could be misleading; and

(b) It is appropriate that the board approves any earnings guidance statements before being released to the market.

Entities should also be careful to avoid providing 'de facto' earnings guidance. ASX notes that this may occur if the entity provides a comment that it:

- is 'happy' or 'comfortable' with, or expects its earnings to be 'in line with' analysts' forecasts, or consensus estimates; or
- expects its earnings to be in line with, or a particular percentage range above or below, the corresponding prior period.

In this case, ASX may ask the entity to issue an announcement to the market confirming the comment so that the whole market is aware of the guidance it has given.

2.2 Earnings surprises

As noted above, a company's earnings for a particular period are not required to be reported to market until the due date specified in Chapter 4 of the Listing Rules. However, the share price of a listed company will quite often be driven by the market expectations of the company's earnings over the near term.

The ASX Guidance Notes states that 'market expectations' may be set by:

- Earnings guidance the company has previously released to the market (published earnings guidance);
- In the case of larger companies covered by sell side analysts, the earnings forecasts of those analysts; or
- In the case of smaller entities not covered by sell-side analysts, the earnings results of the company for the prior corresponding period.

If a company becomes aware that its earnings for current reporting period will differ materially (down or up) from market expectations, it needs to consider whether it has an obligation to notify the market of the fact. This obligation may arise under Listing Rule 3.1. However, in respect of a company that has given published earnings guidance, it may arise also under

[15] *ASX Guidance Note 8, paragraph 7*

section 1041H of the Corporations Act, because failing to inform the market that published earnings guidance is no longer accurate could constitute misleading and deceptive conduct.

2.3 Materiality and disclosure

For the purposes of what is considered a material change from market expectations, ASX draws a distinction between entities that have given published earnings guidance and others that have not.

In the case of the latter, ASX does not consider it appropriate to lay down any rule of thumb or percentage guidelines on when a difference in the actual or projected earnings compared to market expectation ought to be considered sensitive. ASX does, however, suggest that any officer of an entity considering this issue ask two questions:

(a) Would this information influence my decision to buy or sell securities in the entity at their current market price? and

(b) Would I feel exposed to an action for insider trading if I were to buy or sell securities in the entity at their current market price, knowing this information has not been disclosed to the market?

However, because an entity that has released published earnings guidance needs to consider it obligations under Listing Rule 3.1 and for misleading conduct under section 1041H of the Corporations Act, ASX recommends that these entities apply the guidance on materiality in Australian Accounting and International Financial Reporting Standards, that is:

(c) treat an expected variation in earnings to published earnings guidance equal to or great than 10% as material;

(d) treat as expected variation in earnings to published earnings guidance equal to or less than 5% as not being material.

Where the expected variation to published earnings guidance is between 5% and 10%, the entity needs to form a judgment, based on all circumstances, as to whether or not the variation is material.

Before an entity has to disclose information about an expected variation in earnings, the entity needs to reasonably certain that there will be such a difference. For this reason ASX expects that disclosure issues about market sensitive earnings surprises are more likely to arise towards the back end of a reporting period, as there will be a greater degree of certainty as to whether the entity's will materially differ from market expectations.

2.4 Case studies

Some examples of the action taken by the regulator in response to breaches of the continuous disclosure requirements in respect of earnings surprises include:

(a) In 2006, Multiplex Group provided an enforceable undertaking to ASIC (without admission) after its failure to disclosure a material change in profit on the Wembley National Stadium Project in London. The entity secured a $32 million compensation fund for the investors affected.

The alleged breach arose from a board meeting on 2 February 2005. At that meeting, the board decided to adjust the profit forecast down from 35.7 million pounds to zero, but the change was not announced to the market until 24 February 2005.[16]

[16] *ASIC Media Release 06-443MR.*

ASIC contended that Multiplex's board decision was price sensitive and should have been disclosed before the commencement of trade on 3 February 2005. Multiplex contended that until its external auditors had completed a review of the adoption of a zero profit margin from the Wembley project, it would not be possible to issue a general statement on the profit of the project.[17]

(b) In 2010, Nufarm Ltd was required to pay a penalty of $66,000 and provide an enforceable undertaking to ASIC due to its failure to comply with continuous disclosure obligations between 1 December 2009 and 2 March 2010. The enforceable undertaking required Nufarm to engage an independent external consultant to review its financial reporting and disclosure systems and implement effective changes.

The relevant background is that at a board meeting on 11 February 2010, the board were provided with financial forecasts and evidence from senior executives that the expected operating profit for the half year ending January 2010 would be an amount representing an 89% fall from the after-tax net operating profit in the previous corresponding period. Nufarm did not release a financial forecast until 2 March 2010.

Despite Nufarm chairman and managing director addressing the AGM of the company on this issue prior to such announcement, their disclosures did not provide the relevant details, however qualified, of the extent and variation of the earnings.[18] Nufarm were also required to pay $46.6million in settlement of a class action brought by shareholders due to their loss suffered as a result of the non-disclosure.[19]

(c) In 2012, CIMIC Group (formerly, Leighton Holdings Limited) was required to pay $300,000 after receiving three infringement notices from ASIC. CIMIC was also required to provide an enforceable undertaking which required it to review its disclosure practices. The infringements related to a write down of $907 million to the profit forecast announced to market on 11 April 2011, and the failure to immediately notify ASX of information concerning Airport Link project, Victorian Desalination project and AL Habtoor investment.[20]

ASIC said the case demonstrated the need for companies to have procedures in place to comply with their continuous disclosure requirements and to keep investors fully informed. CIMIC delayed their disclosure as they were of the view that they did not have enough certainty on the scale of the downgrade until a review of its operations was formally concluded with a board meeting on 11 April 2011. CIMIC did not admit liability.

(d) In 2017, Adairs Limited were required to pay a penalty of $66,000 due to ASIC's belief Adairs had breached it continuous disclosure obligations between 23 September and 2 November 2016 by failing to inform ASX that its forecast figures for the 2017 full financial year would be materially lower than market consensus. Adairs announced forecast sales on 26 August 2016. On 23 September, the Adairs board received updated financials and revised forecasts, which were materially lower than market consensus. On 2 November 2016, Adairs released a revised guidance for the full financial year 2017.[21]

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[17] *ASIC Corporate & Market Regulation Update Paper presented by Jeremy Cooper, Deputy Chairman ASIC, 2 June 2007.*

[18] *ASIC Media Release 10-255AD.*

[19] *Hadchiti v Nufarm Limited [2012] FCA 1524.*

[20] *ASIC Media Release 12-53MR.*

[21] *ASIC Media Release 17-352MR.*

ASIC alleged that by 23 September 2016, Adairs was aware that the forecast figures for the full financial year 2017 would be materially lower than the market consensus. Adairs denied liability but agreed to pay the penalty to conclude the investigation and to avoid additional costs.

(e) Bellamy's Australia Ltd in 2016, which involved ASIC issuing an infringement notice for the company's failure to comply with its continuous disclosure obligations during 18 October 2016 to 2 December 2016. A trading update was provided by the entity on 2 December 2016. The company paid ASIC a penalty of $66,000 without admission.[22]

ASIC were of the view that the company should have been aware by 18 October 2016 that it was unlikely to achieve market consensus forecasts, given its sale performance in the first quarter. Bellamy's were of the view that it complied with its obligations and did not admit liability.

(f) In 2017, Sirtex Medical Limited was required to pay a penalty of $100,000 after an announcement on 9 December 2016, where the entity projected sales growth to be 4-6% for half year ending 30 June 2017 and 5-11% for the full year, despite previous announcements indicating a 'double digit sales growth will continue'. ASIC alleges the entity should have informed the market by 21 November 2016 of its lower projected sales growth and was in breach between 21 November and 8 December 2016.[23] The company denied the allegation but agreed to pay the penalty to minimise further costs.

[22] *ASX Release dated 11 October 2017 by Bellamy's Australia Ltd.*

[23] *ASIC Media Release 17-320MR.*

Insider Trading

3 Director's Trading Issues

3.1 Overview

There are a number of duties and obligations placed on directors and other officers of companies under Australian law. This paper focuses on insider trading laws and certain insider trading issues that may affect or be relevant to directors of Australian companies.

This section commences with an overview of the duties on directors in relation to a director's use and disclosure of confidential information and then focuses on the statutory prohibition against insider trading, covering:

(a) what insider trading is;

(b) the elements of the insider trading prohibitions;

(c) exemptions and penalties to insider trading; and

(d) insider trading issues in the context of potential control transactions.

3.2 Use of confidential information

A director has certain contractual, fiduciary and statutory obligations in relation to the disclosure and use of confidential corporate information, including information which is commercially sensitive, price sensitive or confidential by virtue of a contractual arrangement.

3.3 Statutory duties

Section 183 of the *Corporations Act 2001* (Cth) (**Corporations Act**) imposes a statutory duty on directors (and other officers and employees) not to make improper use of information acquired by virtue of their position in a corporation to gain, directly or indirectly, an advantage for themselves or someone else or to cause detriment to the corporation.

The section applies if, at the time of the alleged improper use of the information, the person was either an officer or a former officer of the company, provided that the person obtained the information because of the position he or she occupied at the time of obtaining the information.

Breach of section 183 can result in a civil penalty of up to $200,000, disqualification from acting as an officer, compensation and return of profits.

A well-known example of a breach of this statutory duty arose in the *Vizard* case[24], in which the Court held that Vizard used confidential information obtained by reason of his position as a director of Telstra Corp Ltd to buy and sell shares and thereby made improper use of that information. The Court held that there were three separate breaches of section 183(1) (and its predecessor) based on the share trading between the three companies involved. The Court imposed a pecuniary penalty of $130,000 for each breach of director's duty (a total of $390,000) and also imposed an order disqualifying Vizard from managing companies for 10 years.

[24] *Australian Securities and Investments Commission v Vizard* (2005) 219 ALR 714.

Section 184(3) of the Corporations Act provides that a person who obtains information because they are, or have been, a director or other officer or employee of a corporation must not use that information dishonestly:

(a) with an intention of directly or indirectly gaining an advantage for themselves, or someone else, or causing detriment to the corporation; or

(b) recklessly as to whether the use may result in themselves or someone else directly or indirectly gaining an advantage, or in causing detriment to the corporation.

A breach of section 184 can result in a criminal penalty of a fine up to $220,000 and/or up to 5 years imprisonment.

The application of the above statutory duties are not confined to circumstances captured by the insider dealing prohibitions which are discussed separately in the sections below.

3.4 Contractual and fiduciary obligations

In Australia, the general law continues to apply concurrently with statutory duties, and a director also has a common law fiduciary duty of confidentiality which restricts directors from using or divulging confidential information of a company which is not public knowledge.

Directors will often also have contractual obligations to ensure that they keep any information regarding the company and its proposed dealings confidential. Such obligations may arise under:

(a) deeds of indemnity, insurance and access commonly entered into by directors which often include an undertaking by the relevant director that he or she will not disclose confidential information to any other person except in very limited circumstances;

(b) a company's disclosure policies under which directors commonly warrant that he or she will maintain confidentiality to protect the company's trade secrets and confidential information; and

(c) a director's contract of appointment, which commonly includes provisions to the effect that the confidentiality of all confidential information acquired during the term of the director's appointment will be maintained.

3.5 Summary of the insider trading prohibition

Insider trading is in general terms the trading of securities or other financial products by a person in possession of non-public price sensitive information (**inside information**).

This section commences by discussing rationales for prohibiting insider trading and then examines the provisions of Pt 7.10 Div 3 of the Corporations Act in detail.

3.6 Rationales for prohibited insider trading

There are a number of rationales for prohibiting insider trading, including:

(a) **Fiduciary Duty** – Preventing officers from abusing their position of trust by dealing in securities when that person possesses non-public information.

(b) **Conflict of Interest** – Ensuring that an officer makes decisions which are free from self-interest (for example, in relation to trading of securities and disclosing information).

(c) **Market Integrity** – To promote investor confidence in the fairness of markets.

3.7 What are the insider trading prohibitions?

In broad terms, under section 1043A of the Corporations Act, an "insider" must not:

(a) *apply for, acquire, or dispose* of relevant Division 3 financial products in that company or enter into an agreement to do any of those things (**Dealing Prohibition**);

(b) *procure* (incite, induce or encourage) another person to apply for, acquire, or dispose of relevant Division 3 financial products, or enter into an agreement to do any of those things (**Procuring Prohibition**); or

(c) *communicate* (or "tip") the inside information to another person knowing that the other person would (or would be likely) to apply for, acquire or dispose of relevant Division 3 products (or enter into an agreement to do so) or procure another person to do so (**Tipping Prohibition**). The Tipping Prohibition is limited to the communication of information relating to the securities of listed companies, it does not extend to the securities of proprietary or unlisted public companies.

3.8 What are Division 3 financial products?

Section 1042A defines "Division 3 financial products" to include:

(a) securities (eg shares, options to acquire shares, debentures);

(b) derivatives (eg ETOs, swaps and futures contracts);

(c) interests in a managed investment scheme;

(d) Government stocks, bonds or debentures;

(e) superannuation products; and

(f) any products that are able to be traded on a financial market (eg ASX).

3.9 What is information?

For the purposes of the insider trading provisions of the Corporations Act, the expression "information" is defined broadly and includes:

(a) matters of supposition and other matters which are insufficiently definite to warrant being made known to the public; and

(b) matters relating to the intentions or likely intentions of a person.

3.10 Elements of the prohibitions

Apart from the particular kinds of conduct involved (trading, procuring and communicating respectively) the elements of the offences are the same, namely:

(a) they apply only when a person **possesses information** or is otherwise deemed to possess information;

(b) the information must not be **generally available**;

(c) the defendant must **know, or ought reasonably to know**, of the significance of the information; and

(d) if the information were "generally available", a reasonable person would expect the information to have a **material effect** on the price or value of the relevant Division 3 financial products.

These four elements are discussed in further detail below.

3.11 Possession of information (section 1042G and 1042H)

The insider trading prohibition applies regardless of how or from whom a person becomes aware of the inside information. There need not be a connection between the insider and the company to which the information relates and an insider need not be an officer of the company.

Even if a person receives the information inadvertently, they will still be an insider if they know or ought reasonably to know that it is inside information.

Although the concept of possession of information is not defined in the Corporations Act, it is extended by sections 1042G and 1042H, as described below.

A body corporate is treated as possessing any information which came into its officer's possession in the course of performance of his or her duties, or which its officer knows or ought reasonably to know because he or she is an officer of the body corporate.[25] Accordingly, subject to certain exemptions and defences, if a director is in possession of inside information concerning another company, the company will be deemed to also be in possession of that information, and will therefore be restricted from dealing in securities in the other company.

Section 1042H extends this concept to partnerships, with a member of a partnership being treated as possessing any information possessed by another member or employee of the partnership if such information came into the person's possession in his or her capacity as a partner or in the course of performance of duties as such a member or employee of the partnership.

3.12 Information that is not generally available (section 1042C)

Information is considered to be "generally available" if:

(a) it consists of a readily observable matter;[26] or

(b) it has been made known in a manner that would, or would be expected to, brought to the attention of persons who commonly invest in Division 3 financial products of a kind whose price or value might be affected by the information and a reasonable period for it to be disseminated among such persons has elapsed since it became known;[27] or

(c) it consists of deductions, conclusions or inferences made or drawn from either readily observable matter or information made known as mentioned in section 1042C(1)(b).[28]

Generally speaking, information will be "generally available" if it has been released to the ASX, published in half-yearly and annual reports or disclosure documents, or has otherwise been made generally available to the investing public and a reasonable period of time has elapsed after the information has been disseminated in one of these ways.

It is sometimes difficult to determine when information is generally available, particularly as it is not clear what is meant by "readily observable matter". In *R v Firns* (2001) 38 ACSR 233 Mason and Kirby made a number of observations, noting among other things that information being "available, understandable and accessible" is a key consideration. Carruthers J

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[25] *Corporations Act s 1042G(1).*

[26] *Corporations Act s 1042C(1)(a) and see R v Fims (2001) NSW CCA 191 (21 May 2001) - Court decision handed down in PNG was readily observable to a significant group of the public.*

[27] *Corporations Act s 1042C(1)(b) and see Mt Kersey Mining Case - trader intended to wait 30 minutes after release of information about nickel discovery on tenement next to Mt Kersey property.*

[28] *Corporations Act s 1042C(1){c).*

dissented, distinguishing "available" from "readily observable" and noted that members of the public should not have to do a meticulous search of available information to satisfy this limb.

3.13 Knowledge (section 1042A)

The insider must know, or ought reasonably to know that:

(a) the information is not generally available; and

(b) if it were generally available, a reasonable person would expect it to have a material effect on the price or value of those Division 3 financial products.

3.14 Material effect on the price of Division 3 financial products (section 10420)

Information has a material effect on the price or value of securities if, and only if, a reasonable person would expect that information to, or to be likely to, influence persons who commonly acquire Division 3 financial products in deciding whether or not to deal in the relevant Division 3 financial products.

The question that arises in this context is what securities must the information have a material effect on? That is, is it the securities in the relevant company generally or is it limited to the securities which are the subject of the relevant transaction?

It has been held that the inside information must be material to the particular Division 3 financial products being traded, rather than products of that class generally.[29]

In *Exicom Pty Ltd v Futuris Corp Ltd*[30] the Supreme Court of New South Wales held that the reference to material effect on price or value of securities was a reference to the particular securities being traded rather than the securities generally, and as the share price was fixed between the relevant parties, both of whom had access to the inside information, this was not a situation in which an insider was making use of information in a market to gain an advantage over an outsiders.[31]

In *Westgold Resources NL v St George Bank Limited*[32], Westgold challenged the exercise of a put option by St George Bank on the basis that the bank was in possession of inside information at the time and could therefore not exercise the put option. Anderson J rejected this argument, concluding that any inside information held by the bank could do nothing to advantage the bank by influencing the price, as the securities to be delivered under the put option were at a set price under the terms of the put option agreement.[33]

3.15 Geographical application

The insider trading prohibitions apply in relation to acts and omissions within Australia (regardless of where the issuer of the products is formed, resides or is located and of where the issuer carries on business), and also apply to acts and omissions outside Australia in relation to products issued by:

(a) a person who carries on business in Australia; or

(b) a body corporate that is formed in Australia.

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[29] *Exicom Pty Ltd v Futuris Corp Ltd* (1995) 18 ACSR 404 and *Westgold Resources NL v St George Bank Limited* (1998) 29 ACSR 396.

[30] *(1995) 18 ACSR 404.*

[31] *Ibid 411.*

[32] *(1998) 29 ACSR 396.*

[33] *Ibid 440.*

3.16 Examples of inside information

The following list is illustrative only. Inside information could include the following:

(a) a material increase or decrease in the company's financial performance from previous results or forecasts;

(b) a proposed material business or asset acquisition or sale by the company;

(c) a successful tender for a material contract;

(d) the damage or destruction of a material operation of the company;

(e) the launch of a material new business by the company;

(f) proposed material legal proceedings to be initiated by or against the company;

(g) regulatory action or investigations undertaken by a government authority;

(h) a possible change in the company's capital structure, including a proposal to undertake a new issue of shares;

(i) any new financing or a material change to the terms of existing financing;

(j) a proposed dividend;

(k) senior management changes; and

(l) other information that is being withheld in accordance with the exception to the continuous disclosure requirements in ASX Listing Rule 3.1A.

It is important to note that the quality and character of information can change from time to time. Information which may not initially be considered material (and therefore not inside information) may later become material (and therefore become inside information) due to a change in circumstance. Conversely, information that is currently inside information may later cease to be price sensitive due to a change in circumstance or lapse in time such that the information is no longer relevant, material or accurate.

For example, non-public forecasts of future earnings and sales of a company may constitute inside information because the future profitability of the company could be derived by a person from that information. However, those forecasts may lose their character of being inside information if, for example, the underlying assumptions of those forecasts changed in a significant way (for example, due to a material change in macroeconomic conditions or changes in tax laws).

3.17 Application of insider trading provisions to unissued securities and issuers

Do the insider trading prohibitions apply to unissued securities?

There is no debate over whether the insider trading prohibitions apply to issued securities such as shares and options (refer to the definition of Division 3 financial products at section 3.8 above). However, there is some uncertainty as to whether the prohibitions extend to the issue of new securities.

In *Exicom Pty Ltd v Futuris Corp Ltd*[34] the Supreme Court of New South Wales in considering section 1002G (now section 1043A) which used the words 'subscribe for' rather than 'apply for', held that the former section 1002G had no application to a subscription for new shares

[34] *(1995) 18 ACSR404.*

and that "shares in the body corporate" within the definition of securities in the former section 1002A(1) (now sections 761A and 1042A) excludes unissued shares.

This view has been criticised by a number of sources, in particular some commentators have formed the view that the Exicom decision has been overridden by legislative amendments, emphasising that section 1043A replaced the term 'subscribe' with 'apply' and no longer applies. This analysis draws support from the following provisions of the Corporations Act:

(a) section 1043L(2) which applies if an insider applied for or agreed to apply for Division 3 financial products and therefore accords the issuer of those products the right to seek compensation for any damage it has suffered; and

(b) section 761E provides that if a financial product is issued to a person, the person "acquires" the product. This section further provides that a financial product is issued to a person when it is first issued, granted or otherwise made available to a person and this would likely include previously unissued securities.

Given the apparent legislative intention, it is likely that applications for unissued Division 3 financial products are within the scope of section 1043A despite the Exicom decision.

Further, it is noted that the Corporations and Market Advisory Committee (**CAMAC**) considers that offerees who subscribe for new issues when aware of inside information not known to the issuer should remain subject to the insider trading laws, stating that the amendments to sections 761E and 1043A override the Exicom decision and the insider trading provisions now apply to the issue of new securities.[35]

Do the insider trading prohibitions apply to issuers of securities?

There is some uncertainty surrounding the application of the insider trading laws to an issuer of securities.

In *Exicom Pty Limited v Futuris Corp Ltd*[36] it was a held that a company cannot be an insider in respect of its own securities. That is, a company that trades in its own securities (eg under a new issue or a buy-back) whilst in possession of non-public, price sensitive information does not contravene the insider trading laws.

CAMAC has expressed the view that the Exicom decision has been overridden by legislative amendments made in March 2002 (in particular, section 761E and 1043A(1)(c) of the Corporations Act) and that as a result the insider trading laws now apply to issuers. It is not entirely clear how those amendments achieved this outcome.

CAMAC has, however, recommended that further legislative amendments be made so that the insider trading prohibitions do not apply to a company making a general securities issue or conducting a buy-back where the company is subject to a statutory disclosure regime for that issue or buy- back.[37]

3.18 Dealings in other companies

Dealings in securities of other entities associated with or connected with a company (such as the company's customers or joint venture partners) where the company possesses inside information in relation to that associated entity may also be caught by the insider trading prohibitions.

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[35] *CAMAC, Insider Trading Report (2003), 19 [2.2.3 and Recommendation 13].*

[36] *(1995) 18 ACSR 404.*

[37] *CAMAC, above n 12, 17.*

The issue commonly arises in the context of cornerstone equity investments in listed companies where the investor acquires a substantial shareholding in the company, as well as a right to nominate a director to be appointed to the board of directors of the company. The investor will at times possess, or be deemed to possess, inside information regarding the listed company either through information received by its nominee director or alternatively through joint venture opportunities developed between the investor and the company. The difficulty is that, subject to a relevant defence or exemption applying, the investor will be prevented from dealing in the listed company's securities until all inside information it possesses becomes "generally available" or otherwise ceases to be inside information.

There are, however, structures that can be put in place (such as Information Barriers) to ensure that a person in the position of the investor can pursue the strategic benefits of the investment at a shareholder and board level, and still maintain an ability to deal in the relevant company's securities. The Information Barriers defence and other defences and exemptions to the insider trading prohibitions are discussed in further detail below.

3.19 Defences and exemptions to insider trading

There are certain defences and exceptions which may be available to negate liability under the insider trading prohibitions. Some of the main defences and exceptions are discussed briefly below.

It is important to remember that the onus of proof lies on the person relying on the defence or exception to establish that the relevant defence or exception is available on the *balance of probabilities*.

3.20 Withdrawal from a registered managed investment scheme

Section 1043B of the Corporations Act provides a limited defence in respect of a member's withdrawal from a registered managed investment scheme if the amount paid to the member on withdrawal is calculated, so far as is reasonably practicable, by reference to the underlying value of the assets of the scheme, less any reasonable charge for acquiring the member's interest.

3.21 Underwriters

Section 1043C(1) of the Corporations Act provides an exception to the Dealing Prohibition where an underwriter enters into an underwriting agreement or meets a commitment under such an agreement.

Section 1043C(2) of the Corporations Act provides an exception to the Tipping Prohibition where information is communicated solely to procure a person to enter into an underwriting agreement or sub-underwriting agreement, or to subscribe for the securities. The exception from the Tipping Prohibition covers the communication of any information relating to the securities. It permits the underwriter to communicate to any potential subscribers. However, it does not provide any protection for the subscribers.

This exception is limited to securities and managed investment products.

3.22 Compliance with legal requirements

Section 1043D of the Corporations Act provides an exception to the Dealing Prohibition, in respect of an acquisition of financial products pursuant to a requirement imposed by the Corporations Act. For example, in relation to arrangements, reconstructions and takeovers, section 414 and Ch 6A of the Corporations Act may require a body corporate to purchase shares from dissenting shareholders.

Section 1043E of the Corporations Act provides an exception to the Tipping Prohibition where the inside information is communicated pursuant to a requirement imposed by the Commonwealth, a state or territory or any regulatory authority.

3.23 Information Barrier defence

The Information Barrier defence is commonly relied upon to manage insider trading risk. This is particularly the case in the context of multi-service broking houses where for example, the corporate advisory arm might have inside information in relation to a takeover while its broking arm might be dealing in the target's company shares on behalf of its clients. It is also relevant in the context of a range of corporate transactions such as takeovers, schemes of arrangement and share placements.

Sections 1043F and 1043G of the Corporations Act provide that companies, partnerships and bodies corporate will not be precluded from entering into transactions merely because of information in the possession of an officer, partner or employee if the following three elements of the defence are satisfied:

(a) the decision to enter into the transaction or agreement was taken on its behalf by a person or persons other than the relevant officers, partners or employees who possessed the inside information;

(b) there were in operation at the time the decision to deal was made, arrangements that could reasonably be expected to ensure that the inside information was not communicated to the person or persons who made the decision, and that no advice with respect to the transaction or agreement was given by anyone who possessed the information; and

(c) the information was in fact not communicated and no such advice was given.

This exception applies to the Dealing Prohibition (but not to the Procuring Prohibition or the Tipping Prohibition), and it will only apply to information acquired after the Information Barrier is erected.

Under Australian law, Information Barrier require formal documentation (including written directions to affected officers and employees), and involve a combination of the following arrangements:

(a) a written policy, supported by appropriate internal correspondence and external legal advice

(b) physical separation of resources on either side of the Information Barrier in order to insulate them from each other

(c) written direction to the relevant personnel, to emphasise the importance of not improperly or inadvertently divulging confidential information

(d) strict and carefully defined procedures for dealing with a situation where the Information Barrier needs to be crossed and maintaining proper records in such a case, and

(e) monitoring by compliance officers of the effectiveness of the Information Barrier.

There is some uncertainty as to how tight the Information Barrier arrangements must be to satisfy section 1043F. One problem is that certain kinds of decision making need to be taken at a senior level or even by the board of directors, to whom the information-gatherers report. If a board puts into place arrangements which prevent the board from having access to

information reasonably necessary for their own decision making, their conduct in putting such arrangements in place could be inconsistent with their fiduciary duty as directors.

Another problem is how far the arrangements need to go to qualify as arrangements that could reasonably be expected to ensure the separation of information and trading decisions.

Information Barrier arrangements for partnerships are even more problematic than for bodies corporate. The partner's personal economic interests and fiduciary responsibilities may coincide in requiring him or her to have access to information throughout the partnership. Partners may be reluctant to be excluded from information or trading decisions, by Information Barrier arrangements, where the information or decisions could lead to profit or liability for the firm. A partner might find it impractical to take advantage of the statutory defence in section 1043G for fear that by doing so he or she might lose control of a situation which could lead to liability for breach of fiduciary duty or negligence otherwise than through a transaction in securities.

CAMAC has recommended that this defence be extended to also cover the Procuring Prohibition.[38]

3.24 Information symmetry defence

The Corporations Act provides a defence to the insider trading prohibitions where both parties to a transaction know or ought reasonably to know of the same inside information (section 1043M(2) and (3) of the Corporations Act).

The information symmetry defence is often relied upon in circumstances where a person acquires securities after due diligence (which involves the receipt of non-public information) on the basis that the person will not subsequently deal in the securities until the information is public. In order to make out the defence, a letter is exchanged under which the purchaser and the vendor acknowledge that material information has been disclosed by reason of which the parties are satisfied there is symmetry of information and the purchaser undertakes not to deal until such material information is public.

While the defence applies only to criminal proceedings and not in civil proceedings, the Court can relieve a person from civil liability for a breach (section 1043N of the Corporations Act) if the defence is made out. A Court may be inclined to do so, for example, if the parties to the discussions are of equal bargaining power.

3.25 Knowledge of own intentions or financial products transactions

Pursuant to the 'own intentions' exemptions under sections 1043H to 1043J, the Dealing Prohibition does not apply where the relevant information is the insider's awareness of their own intentions.

For example, under section 1043I of the Corporations Act, a body corporate will not contravene the Dealing Prohibition by entering into a transaction or agreement in relation to financial products issued by another person merely because the body corporate is aware that it proposed to enter into, or have previously entered into or proposed to enter into, one or more transactions or agreements in relation to financial products issued by the other person or a third person.

Accordingly, a potential bidder is not precluded from dealing in target securities merely because it is aware of its own intention to make a bid.

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[38] *CAMAC, above n 12, 6 [1.6 and Recommendation 6].*

However, this defence would not be available where the inside information relates to the intentions of others (such as other members of a bid consortium). In this regard, CAMAC has recommended that sections 1043H-J should be amended to make it clear that members of a prospective takeover bid consortium can acquire Division 3 financial products on behalf of that consortium, but not through the intended bid vehicle (eg the offeror/bidder), prior to the market becoming aware of the bid.[39]

Under the CAMAC recommendation, allowing bid consortium members to acquire on behalf of the consortium before the market becomes aware of the bid is consistent with the policy of the current exemption, namely to promote takeover bids which may benefit shareholders. However, CAMAC states that bid consortium members who trade on their own behalf before the market is aware of the takeover bid are not furthering the bid, and therefore should not have any comparable exemption, even where they have the consent of the other bid consortium members.

The Howard Government in 2007 stated that it accepted CAMAC's recommendation,[40] although no changes have been subsequently made to the Corporations Act to reflect the recommendation.

3.26 Consequences of insider trading

A person who breaches the insider trading provisions could be subject to criminal liability (substantial fines and/or imprisonment may be imposed) or civil liability (substantial pecuniary penalties can be imposed).

In addition, a person who contravenes or is involved in a contravention of these provisions may be liable to compensate any person who suffers loss or damage because of the conduct.

Such conduct would also prompt disciplinary action by the company, which may include termination of employment.

3.27 Criminal consequences[41]

A contravention of the insider trading provisions is an offence under section 1311 of the Corporations Act.

The maximum level of criminal sanctions that may be imposed on both individuals and bodies corporate for breaches of the penalties for insider trading (and other market manipulation) has recently been substantially increased.[42]

For individuals, the maximum period of imprisonment was doubled from 5 to 10 years. The maximum pecuniary penalty has more than doubled from a maximum fine of $220,000, to the greater of either:

(a) $495,000; or

(b) if the Court can determine the value of the benefit obtained from the conduct constituting insider trading, three times that value.

For corporations, the maximum pecuniary penalty for such offences has increased substantially from $1.1 million, to be the greater of:

(a) $4,950,000; or

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[39] *Ibid 7 [1.7].*

[40] *CAMAC, Insider Trading Position and Consultation Paper (2007), 5.*

[41] *Corporations Act s 1311 and Schedule 3.*

[42] *Corporations Amendment (No 1) Act 2010 (Cth), commenced 13 December 2010.*

(b) if the Court can determine the value of the benefit gained from the conduct constituting insider trading, three times that value; or

(c) if the 'value of the benefit' cannot be determined, 10% of the corporation's annual turnover for the 12-month period before the offence was committed.

3.28 Liability under the civil penalty provisions

A successful civil prosecution can result in a penalty of $1 million for a body corporate and $200,000 for an individual, together with an order under section 1317H requiring the offender to compensate a person for damage that resulted from the contravention.

3.29 Calculating the price for a civil offence

The recent Federal Court decision in *Australian Securities and Investments Commission v Petsas* [2005] FCA 88 marked the first occasion in which a court imposed a civil penalty for insider trading contraventions and provides a likely benchmark for future cases.

In *Petsas*, ASIC commenced civil proceedings against the defendants, seeking declarations that they had contravened the insider trading provisions of the Corporations Act, together with civil penalties, compensation orders and costs. The defendants agreed to the declarations, the imposition civil penalties and orders to pay $128,495 in compensation to the counterparties to the options contracts and to pay ASIC's costs of $93,254. Therefore, the only issue for determination by the Court was the amount of the civil penalty that should be imposed.

Finkelstein J observed that this was the first occasion upon which a court had been required to impose a civil penalty on a person who had contravened the insider trading provisions. His Honour recognised the benefits to the community which flowed from an increase in the use of civil proceedings to punish insider trading contraventions. However, the use of civil remedies to punish offenders for what were essentially criminal offences created problems for the courts.

With no case law to guide him, Finkelstein J reviewed the criminal penalties imposed for insider trading contraventions since 1992. This suggested that if the case had been heard by a criminal court, a minimum sentence of between 3 to 6 months imprisonment would have been imposed.

Finkelstein J considered that Parliament's intention was that the imposition of civil penalties for insider trading should serve as a punishment to the offender, as well as act as a deterrent to others. In assessing the appropriate penalty in the circumstances, his Honour took into account the personal circumstances of the defendants, their admissions of guilt, their remorse and the impact of the proceedings on their employment prospects. On the other hand, the seriousness of the offences, the size of the profits made and the need to deter others warranted that at least moderate penalties be imposed. In the circumstances, Finkelstein J imposed civil penalties of $75,000 and $65,000 respectively (a greater penalty was imposed on the defendant who had breached his employer's trust).

3.30 Compensation

The two compensation provisions for insider trading are set out in sections 1043L and 1317HA of the Corporations Act.

Section 1043L allows recovery of damages under section 1317HA if:

(a) a person (the insider) possesses information that is not generally available;

(b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of Division 3 financial products (other than derivatives);

(a) the insider knows, or is reckless, as to those matters; and

(b) the insider, whether as principal or agent, contravenes section 1043A(1) by applying for, acquiring or disposing of Division 3 financial products, or entering an agreement to do so, or procuring another person to do so.

The amount of compensation which may be recovered by an action under section 1317HA, is the difference between the price at which the securities were traded (ie issued, acquired or disposed) or agreed to be traded at and the price at which they would have been likely to be traded at had the inside information been generally available.[43]

It is important to note that sections 1043L and 1013HA only apply to a contravention of the Dealing and Procuring Prohibitions, and accordingly an action to recover compensation as a result of a breach of the Tipping Prohibition cannot be brought under these sections.

4 The Procuring and Tipping Prohibitions – Communications between Target Directors and Potential Bidders

4.1 Application of the Procuring and Tipping Prohibitions in the context of takeovers

Impending takeovers provide opportunities for pre-bid trading and provide futile ground for the clash between the duties of directors and the Procuring Prohibition and Tipping Prohibitions.

It has become increasingly common for target directors to permit a potential bidder (or bidders) to undertake due diligence on the target to enhance or facilitate the prospects of an attractive bid proposal emerging. This process may result in the disclosure of inside information to the potential bidder.

Subject to a relevant defence or exemption applying, a bidder will be restricted from trading in the target's securities whilst in possession of inside information.

However, as discussed in section 3.7 above, a person with inside information in relation to a company must not, amongst other things:

(a) induce or encourage a person to acquire securities in the company (ie Procuring Prohibition); or

(b) communicate that information to a person if the person is likely to acquire securities in the company or procure another person to do so (ie Tipping Prohibition).

Accordingly, the disclosure of any inside information by target directors to a potential bidder under a due diligence process which is designed to facilitate and encourage a bid for the target, may result in the target directors being liable for a breach of the Procuring Prohibition or the Tipping Prohibition.

Although a listed company is subject to the continuous disclosure requirements under the ASX Listing Rules, it may be withholding price sensitive information from disclosure in reliance on the exception in ASX Listing Rule 3.1A (for example, management forecasts of the target which are price sensitive).

In *ICAL Ltd v County Natwest Securities Ltd* (1988) 39 NSWLR 214 at 255, Bryson J suggested that such forecasts could be price sensitive. However, the Court recognised the

[43] *Corporations Act s 1043L.*

conflict between a directors' duty to act bona fide in the interests of the company and the communication of such inside information. In that case, Bryson J considered the directors' duty to seek the highest share price in a takeover took priority over the prohibition on tipping (under the prior legislation) and the Court therefore refused to grant an injunction restraining the target company or its directors from disseminating price-sensitive information to third parties with a view to soliciting a rival takeover bid, as such exercise was in the best interest of the target's shareholders. The potential bidders could not, however, acquire any target shares until such information became public.

Further in *International All Sports Limited* [2009] ATP 5, the Takeovers Panel found that certain confidential forecast information provided to Centrebet during its due diligence was price sensitive when it was disclosed and had not since ceased to be price sensitive. It was on this basis that the initial Panel found that the 12 month standstill entered into by Centrebet was justified.

Of course, it is open to the target to publicly release any confidential price sensitive information before attempting to attract a rival bidder. However, this is unlikely to be a desirable outcome for the target. In practice, it seems that target directors attempt to protect themselves from insider trading liability by subjecting would be bidders to a standstill or other contractual restrictions which prevents the bidder from engaging in any activity that would breach the insider trading provisions of the Corporations Act.

4.2 Defences for the directors

The potential conflict between the need for target directors to act in the best interests of the company on one hand and a director's potential liability under the Procuring and Tipping Prohibitions was identified by CAMAC in its *Insider Trading Discussion Paper.*[44]

In this paper, CAMAC initially proposed that directors of target companies should be able to absolve themselves of liability under the insider trading laws by proving that:

(a) the purpose of the communication by the director was to encourage the third party to make a takeover bid; and

(b) the director had taken all reasonable steps to ensure that the third party did not acquire securities in the target company on the market until after the information became generally available.[45]

However, CAMAC ultimately formed the view that target directors cannot control the actions of third parties and such communications with reliance on this proposed defence were open to abuse. Accordingly, CAMAC recommended that there should be no specific exemption for target company directors communicating inside information to third parties.[46]

Directors' communication of such information to third parties must therefore ensure that appropriate contractual restrictions are in place to reduce the likelihood of any on market acquisitions by a third party in possession of inside information (for example, by implementing standstills as discussed further below or the imposition of other appropriate contractual restrictions).

[44] CAMAC, *Insider Trading Discussion Paper* (2001), 81.
[45] Ibid 83.
[46] Ibid 38 [3, 14].

4.3 Use of standstills

To address the potential conflict between the duty of a director to act in the best interest of the target company and potential liability under the Tipping and Procuring Prohibitions, it is common for a target to require a bidder to agree to a "standstill" as a condition to undertaking due diligence.

A standstill is a promise by a bidder not to deal in shares of the target for a specified period except with consent of the target's board.

Standstill clauses reduce the risk of the bidder using any sensitive confidential information obtained in the due diligence process to deal in the target's securities and can help reduce the liability of the target's directors under the Procuring or Tipping Prohibitions.

The following clause is an example of a typical standstill undertaking:

> *'Without the prior written approval of the Target (which the Target may withhold in its sole discretion), the Bidder must not, and must ensure that its related bodies corporate and representatives (alone or with others) do not, for a period of 12 months from the date of this deed, in any manner:*
>
> *(a) acquire, purchase, sell, finance an acquisition or purchase or agree to purchase, sell or finance an acquisition or purchase of:*
>
> *(i) any securities (or direct or indirect rights, warrants or options to acquire any securities) of the Target;*
>
> *(ii) any derivative instrument or other financial product (including, without limitation, any cash-settled equity swap) affording the Bidder an economic exposure to the Target or to movements in the price of any securities of the Target; or*
>
> *(iii) property of the Target or its Related Bodies Corporate (other than property transferred in the ordinary course of business of the Target or its Related Bodies Corporate); or*
>
> *(b) initiate any rumour or media comment or announce an intention to do any of the things mentioned in paragraph (a); or*
>
> *(c) solicit proxies from shareholders of the Target or its related bodies corporate, or otherwise seek to influence or control the management or policies of the Target; or*
>
> *(d) aid, abet, counsel, procure, co-operate, assist or induce any other person in doing any of the things mentioned in paragraph (a), (b) or (c).'*

In the case of *International All Sports Limited* [2009] ATP 5, a 12 month standstill came before the Takeovers Panel for consideration. In that case, Centrebet had agreed to a 12 month standstill with International All Sports Limited (IAS). Centrebet commenced proceedings with the Panel alleging that the standstill was unacceptable on the basis that it was an anticompetitive lock-up arrangement and amounted to a frustrating action.

Initially the Panel declined to make a declaration of unacceptable circumstances on the basis that the standstill was commercially justifiable having regard to the information disclosed to Centrebet during its due diligence. The following points came from that decision:

(a) during the due diligence, IAS had provided certain forecast information to Centrebet. The Panel was of the view that the forecast information was price-sensitive information when it was provided to Centrebet and had not ceased to be price sensitive;

(b) a standstill was a valid mechanism for a target to use to disclose price sensitive information to a bidder, and protected a target against the forced disclosure of that information in the event a bid was made;

(c) the 12 month term of the standstill was justifiable having regard to the forecast information provided. In forming this view, the Panel considered that a standstill for 6 to 12 months is consistent with market practice; and

(d) a standstill is a useful way to facilitate a sale process for a company, it helps to protect a target company and its officers from insider trading liability and will ultimately advance shareholders' interests.

The initial Panel's decision was appealed. The review Panel also declined to make a declaration of unacceptable circumstances and agreed with the decision of the initial Panel that the standstill was commercially justifiable. In its decision, the review Panel stated that the provision of commercially sensitive information also justified the use of a standstill by a target company.

Conflicts

5 Nominee Directors and Confidential Information

5.1 Nominee Directors

A nominee director is generally a director who is appointed by a shareholder, creditor or interest group (whether contractually or by resolution at a company meeting) and who has a continuing loyalty to the appointor or other interest in the company. For the purposes of this discussion, we will focus on a director appointed by a shareholder.

Generally, the fiduciary and statutory duties imposed on directors common to two companies require them to:

- act in good faith and in the best interests of each company;
- to avoid conflicts of interest;
- avoid improperly using their position in each company to gain an advantage for the other company or to cause detriment to either company;
- avoid improper use of information obtained as a director of one company to gain advantage for the other company or to cause detriment to either company; and
- keep the information provided to them in the capacity as director of each company confidential.

The appointment of a nominee director by a shareholder does not abrogate or 'roll back' the duties owed to the appointor (and vice versa). The nominee director must comply with his or her duties to each company at all times.

In the context of a nominee director, the most challenging duty to manage will usually be the duty to avoid conflicts of interest. It seems clear from the authorities that:

- the law doesn't prevent a director from serving on the board of a competing company. However, the conflict rule will need to be adequately addressed. The conflict rule is designed to prevent directors from placing themselves in a position of conflict whereby a personal interest or duty (owed to another) conflicts with their duty to the company;
- it is not the mere existence of a conflict of interest or duty that gives rise to a breach of duty, but rather the pursuit of that interest or preference to the competing duty; and
- there must be a real sensible possibility of conflict, not merely a theoretical or hypothetical position of conflict. A theoretical or hypothetical conflict is not a sufficient reason to deny the validity of the appointment of a person as a director. The approach is to look to whether there is a conflict to be resolved when a particular matter arises for consideration by the board.

As a practical matter, any nominee director should ensure that he or she has duly authorised consent from the appointor before being appointed as a nominee director. This will usually be necessary to ensure that the appointment, and activities of the nominee under such appointment, will not contravene any contractual obligations or duties owed by the nominee director to the appointor.

5.2 Material Personal Conflicts

The conflict of interest rule arises for consideration where a director is in a position in which a material personal interest conflicts, or may possibly conflict, with a duty to the company. The

most common example of this is where a director might have a material personal interest in a contract that the company is proposing to enter into.

The Corporations Act generally requires that a director, who has a material personal interest in a matter that relates to the affairs of the company, give the other directors notice of the interest in the prescribed manner. It also requires that director not be present while the matter is being considered at any board meeting of the company and not vote on the matter.

The director may, however, be present and vote if the non-conflicted directors pass a resolution permitting the conflicted director to do so. The non-conflicted directors must be satisfied that the interest should not disqualify the conflicted director from voting or being present.

Although a conflict of this nature may arise in the context of a nominee director (just as it may with any other director), the more likely area of conflict will usually be that of conflict of duty.

5.3 Conflicts of Duty

A conflict of duty might arise where a director may be influenced against discharging his duty to a company by an inconsistent duty. For example, where a nominee director is called upon as a director of the appointor to make decisions or act in a manner that may be contrary to the best interests of the nominee company.

A conflict of this nature is likely to arise in situations where the appointor and the nominee company are competitors. However, the conflict may also arise in other circumstances.

Certainly, a scenario where this conflict might arise is where the shareholder decides to make a bid for 100% of the nominee company. Although conflicts of duty are not specifically dealt with under the Corporations Act, the law and protocols for dealing with these types of conflicts are no less certain or well established. In short, the director would be required to:

- give notice of the conflict to the other nominee company directors (to the extent it is not already known);
- not be present at any meeting of the nominee company board to discuss the matter; and
- not vote on the matter on the nominee company board.

Another area where a conflict of interest might arise is confidential information. A nominee director will be obliged to keep all information provided to him or her as a nominee director confidential. The nominee director will be subject to the same obligation to the appointor, in respect of its information.

The issue that arises in this context is what is the correct course of action if the nominee director has confidential information of one company which is material or detrimental to the other?

Usually a director would be required to disclose such information to the relevant company to properly discharge his or her duties. However, there will be a competing obligation of confidence which prevents such disclosure.

It seems clear that the nominee director should consider adopting the protocol outlined above. Beyond this, the law is unclear as to what is required. Some authorities have suggested that, in extreme cases, the director has a duty to alert the other directors of any potential detriment, although it is difficult to see how this might be achieved with breaching obligations of

confidence. Matters of this nature really need to be considered on the particular facts, rather than the application of any fixed rule of law.

5.4 Insider Trading

A nominee director may be provided with non-public, price sensitive information relating to the nominee company. This is relevant in the context of the insider trading laws.

Generally, the insider trading laws prohibit a person who has information of this nature in relation to a company from:

- (**trading**) trading (including acquiring and disposing) in shares in the company;
- (**procuring**) procuring, inciting, inducing or encouraging another person to acquire or dispose of shares in the company (or enter into an agreement to do any of those things); and
- (**communicate or 'tip'**) communicate the information to another person knowing that the other person would (or would be likely to) acquire or dispose or shares in the company, or procure another person to do so.

If, as a director of the nominee company, the nominee director is in possession of non-public, price sensitive information relating to the nominee company, the director will not be able to trade in in the securities of the nominee company. If the company is listed, the director will also be bound by the company's Share Trading Policy, which will only allow directors to trade during certain periods.

In addition, to the extent the appointor acquires any non-public, price sensitive information relating to the nominee company through its nominee, the appointor will also be precluded from trading in the securities of the nominee company under the insider trading laws.

Therefore, the appointor should ensure it has an appropriate protocol in place that governs the trading of securities in the nominee company.