MARKET MISCONDUCT PROVISIONS OF THE FINANCIAL SERVICES REFORM ACT: CHALLENGES FOR MARKET REGULATION

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INTRODUCTION

One of the most striking features of Australian corporate and securities regulation is the pace and volume of legislative change. Indeed, as if a whole new subject has been created, we can no longer talk of securities regulation but now financial services regulation. "Financial products" and "financial services" are the new defining concepts. As if that was not enough, the *Financial Services Reform Act* 2001 ("the Act") will require understanding of the untested, but greatly anticipated by its architects, *Criminal Code* and the extension to market misconduct of the little used, but growing in significance, civil penalty regime.

The focus of this paper is Part 7.10 of the Act. Part 7.10's title, "Market Misconduct and Other Prohibited Conduct relating to Financial Products and Financial Services", suggests a broader coverage than it in fact achieves. Essentially, Part 7.10 deals with market manipulation and related prohibitions, some general market misconduct provisions and insider trading. However, the Act creates a whole range of new offences "relating to financial products and financial services" (for example, in connection with preparing and providing a product disclosure statement) not dealt with in Part 7.10.

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For the purposes of this paper, market misconduct includes proposed Chapter 6CA dealing with continuous disclosure (presently found in Part 7.11 of the *Corporations Act* 2001). Throughout this paper, I will be referring to the *Corporations Act* and not to the *Corporations Law*, unless the context requires a distinction to be drawn. One example of this is where I am quoting from the Explanatory Memorandum containing a reference to the *Corporations Law*. Otherwise, I have simply referred to the *Corporations Act*.

As a general proposition, the Government has stated that it is not its intention to substantially alter the effect and operation of the existing market misconduct provisions under the Corporations Act. The Explanatory Memorandum to the Act says that the market misconduct provisions proposed in Part 7.10 of the Act "are based on the current provisions in Parts 7.11 and 8.7 of the *Corporations Law*. These have generally been retained in their current form but their scope has been extended, as appropriate, to apply to all financial products and markets". Textually, there is much in the Act that is familiar and replicates what is presently in the *Corporations Act*. However, it would be a mistake to conclude that the Act brings about no substantial change.

What follows expresses some preliminary views about the operation of the Code and the market misconduct provisions. This raises many complex questions of construction with respect to what the relevant mental elements are that the prosecution might be required to prove. Issues of similar complexity arise with civil remedies, including civil penalties.

OVERVIEW

Among other things, the Act proposes to repeal Chapters 7 and 8 of the *Corporations Act* and enact a new Chapter 7 entitled "Financial Services and Markets". The provisions found in Part 7.10 represent an amalgam of the current provisions in Parts 7.11 ("Conduct in relation to Securities") and 8.7 ("Offences") appearing in a chapter presently entitled "The Futures Industry". In a matter dealt with in more detail below, no mention of the concept of "futures" will be found anywhere in the Act, the issue has been subsumed within "derivatives" – although what may be taken from that, like everything else in this paper, remains subject to the effect of regulations under the Act yet to be concluded and the finalisation of any relevant ASIC policy.

While the Act broadly achieves re-enactment of existing approaches to market misconduct, it will be seen that there are some significant changes, both in the substance of the provisions themselves and the consequences of breach. So far as the former is concerned, some of these changes are referable to the Act's attempt to create a single set of provisions dealing with "financial products" as defined, whereas before there were two sets of provisions dealing with, on the one hand, "securities" and, on the other, "futures". Other issues of substance arise from the application, for the first time, of principles of criminal responsibility under the new Federal *Criminal Code*. So far as the consequences of breach are concerned, the civil penalty regime, presently found in Part 9.4B of the *Corporations Act*, is proposed to be extended to the market manipulation and related provisions and the insider trading provisions (to be called "financial services civil penalty provisions"). A breach of the continuous disclosure provisions will also now be liable to a civil penalty although, curiously, not a "financial services civil penalty" but a newly termed "corporation/scheme civil penalty provision".

Provision for civil compensation has been made for those affected by contraventions of the market misconduct provisions. However, the way in which this has been achieved is complex and probably not as coherent as it could have been. First, a distinction appears to have been drawn for this purpose between financial services civil penalty provisions, on the one hand, and corporation/scheme civil penalty provisions on the other. Recall that, while the continuous disclosure provisions are proposed civil penalty provisions, this was achieved by including them as a new subsection 1317E(1)(ja), making them corporation/scheme civil penalty provisions. The consequence of this is that, by virtue of existing sections 1317J(1) and (2), only ASIC, the corporation or the responsible entity for a registered scheme may apply for a compensation order if a declaration of contravention has been made. Curiously, by virtue of a new subsection, 1317J(3A), in the case of financial services civil penalty provisions, "any other person who suffers damage in relation to a contravention" may apply for a compensation order.

There is more. No distinction is made between continuous disclosure and other market misconduct provisions for the purposes of the operation of sections 1324A (providing for availability of injunctive relief during prosecutions), 1324B (providing for orders to disclose information or publish advertisements) and 1325(2) (permitting a person who has suffered loss because of conduct in contravention of Chapter 6A or Part 7.10 to obtain orders compensating that person).

In addition, in effect as an overlay, special provision is made (see sections 1043L and 1043N) with respect to civil liability arising out of contraventions of the insider trading provisions.

Finally, so far as what I have called the general market misconduct provisions (that is to say, not market manipulation, insider trading or continuous disclosure), and in addition to the regime provided for in existing sections 1324A to 1325(2), civil liability provisions are provided for in section 1041I of the Act. Also, for good measure, relief from Section 1041I liability is provided for as if the provisions in question were civil penalty provisions and the proceedings were eligible proceedings (see the combined effect of sections 1041I(4) and existing section 1317S).

It will be necessary to commence with some analysis of the concept of "financial products" and "financial services", followed by an overview of the key features of the new Federal *Criminal Code* and the extension of the civil penalties regime to market misconduct. The balance of the paper, together with civil liability, is divided according to the following topics:

(a) Market manipulation (including false trading and market rigging – creating a false or misleading appearance of active trading, artificially maintaining trading price, dissemination of information about illegal transactions);

(b) Market misconduct, general (including false or misleading statements, inducing persons to deal, dishonest conduct and misleading or deceptive conduct);

(c) The insider trading prohibitions; and

(d) Continuous disclosure.

FINANCIAL PRODUCTS AND FINANCIAL SERVICES

The linchpins of proposed Chapter 7 are the concepts of "financial products" and "financial services". Both concepts are the subject of elaborate definitions. A comprehensive analysis of both is beyond the scope of this paper. Part 1 Division 3 of the chapter is entitled "What is a financial product?". I provide no more than an overview here and great care must be taken to ensure that any understanding of what a financial product is can be appropriately supported by reference to the legislation, regulations and ASIC policy. This is because, as one note puts it, "references in this chapter to financial products have effect subject to particular express exclusion for particular purposes" and, as we shall see, the concept of financial products is not constant throughout Part 10 of Chapter 7 dealing with market misconduct and related prohibitions. Moreover, proposed Chapter 6CA, dealing with continuous disclosure, still applies to disclosing entities which are required to disclose information about their "securities" that is material and not generally available.

An overview of the approach to be taken in defining what a financial product is can be found in section 762A. Conceptually, a three-step approach is taken. A general definition of financial product is provided in section 763A. Section 764A provides for what financial products are specifically included (whether or not they are within the general definition) or, by section 865A, the subject of an overriding exclusion provision (whether or not the financial product in question would otherwise have been within the general definition).

The general definition of financial product provides that it "is a facility through which, or through the acquisition of which, a person does one or more of the following:

(a) makes a financial investment;

(b) manages a risk;

(c) makes non-cash payments."

For the purposes of Chapter 7, “a particular facility that is of a kind through which people commonly make financial investments, manage financial risks or make non-cash payments is a financial product even if that facility is acquired by a particular person for some other purpose”. All of the elements of the general definition are themselves the subject of further definition pursuant to sections of Chapter 7. This is quite apart from those sections dealing with inclusions and exclusions from the general definition. There is provision for what happens if a financial product is part of a broader facility (see section 762B) and what the position is if a financial product is “an incidental component of a facility that also has other components” (see section 763E which, for the purposes of that section, also contains a definition of “financial product purpose”).

Of present interest, among the financial products that are specifically included are:

- a security (section 764A(1)(a));
- certain interests in relation to a registered scheme (section 764A(1)(b));
- a derivative (although this is a little misleading because one has to consult provisions of section 765A(1)(n) to (p), read with certain subparagraphs of subsections (3) and (4) of section 761D, to tease out what is actually in or out for a particular purpose and, as with so much else in proposed Chapter 7, “anything declared by the regulations not to be a derivative for the purposes of this chapter”;
- a superannuation interest within the meaning of the Superannuation Industry (Supervision) Act 1993.

A range of other financial products are also expressly included dealing with, for example, deposit taking and insurance products. Section 764A(1)(m) also permits the regulations to include a financial product for the purposes of the section.

It is important to again stress that whether or not a particular thing is a financial product or not normally requires many provisions of Chapter 7 to be consulted before being able to answer that question. For example, requirements with respect to product disclosure and product advice often vary depending upon the particular financial product (see special provisions, for example, dealing with a range of general insurance products in section 761G(5) providing that, for the purposes of Chapter 7, if a financial product is, or a financial service provided to a person relates to, a general insurance product (the subject of detailed subsequent provisions), then the product or service is provided to the person as a retail client, if the person is an individual or the insurance product is or would be for use in connection with a small business).

The concepts of “issued”, “issuer”, “acquire and “provide” in relation to financial products are also the subject of separate and qualified definitions (the starting point is section 761E). However, the hidden hand of regulations is ever-present. So, for example, while section 761E(1) says that the section defines when a financial product is issued to a person, and what it means to be an issuer, an acquirer or provider of a financial product, section 761E(7) makes clear that regulations may make provision determining all or any of these concepts for the purposes of Chapter 7 and that regulations “made for the purposes of this subsection have effect despite anything else in this section”.

This short survey does not really do justice (if that is the right word) to the complexity surrounding the denotation of the concept of “financial product” for the purposes of Chapter 7. However, more about that in a moment. I will briefly deal with what a “financial service” is before turning to make some observations about Chapter 7’s approach to financial products and services insofar as the market misconduct provisions are concerned.

Section 766A sets out, for the purposes of Chapter 7, that a person provides a financial service if they:

a) provide financial product advice; or
b) deal in a financial product; or
c) make a market for a financial product; or
d) operate a registered scheme; or

e) provide a custodial or depository service; or

f) engage in conduct of a kind prescribed by regulations made for the purposes of this paragraph.

Again, virtually every element of the definition of financial service is itself the subject of elaborate provision bringing into play a number of other fundamental concepts (for example, "financial product advice", defined in section 766B, provides the basis for a whole range of other provisions, in particular Part 7.6, dealing with the licensing of providers of financial services).

Where does this leave the market misconduct provisions? I deal with this in more detail below, but the position can be briefly summarised as follows:

(a) so far as the market manipulation provisions are concerned, Part 7.10 Division 2 appears to rely on the general definitions of financial products and services (although, as we shall see, some elements of these provisions can only operate in connection with "trading in financial products on a financial market operated in this jurisdiction");

(b) the general market misconduct provisions (as I have defined them) also appear to rely on the general definitions of financial products and services;

(c) the insider trading prohibitions (found in Part 10, Division 3) have their own defined term "Division 3 Financial Products" and means:

1) securities; or

2) derivatives; or

3) managed investment products; or

4) superannuation products, other than those prescribed by regulations made for the purposes of this paragraph; or

5) any other financial products that are able to be traded on a financial market;

As we shall see, there are some curious features to the approach taken here. For example, one consequence of the approach taken to derivatives appears to be a recognition that insider trading can now occur in connection with derivatives over commodities; and

(d) so far as the continuous disclosure provisions are concerned, they basically apply to the securities of a disclosing entity (reflecting perhaps a structural approach that sees the continuous disclosure provisions found in Chapter 6CA of the *Corporations Act*, physically separating them from where they were, alongside the insider trading and other market misconduct provisions in Part 7.11 of the Corporations Act as it was).

CRIMINAL CODE

History and overview

The Act creates a number of new offences. For example it is a strict liability offence to fail to give a disclosure document or statement (see proposed section 952C of the Act). While the creation of a number of new offences does not surprise, the appearance for the first time in the *Corporations Act* of references to the *Criminal Code* is notable. Some States (for example, Queensland and Western Australia) have long had *Criminal Codes* in operation dealing with State criminal law. However, with general effect from December 2001, there will be a Federal *Criminal Code*. The Code is a schedule to the *Criminal Code Act* 1995 (Commonwealth).

The Code is essential reading for anyone seeking to understand provisions of the Act creating criminal liability. This is because, for the first time, Federal legislation creating offences, including the Act when it becomes law, must be read with the Code in order to understand the full extent of a person's legal rights and obligations. This represents a significant departure from the present approach where all the elements of liability are generally found in the offence itself and then applied and construed against a general body of law and practice.

In particular, many of the offences, including the one referred to above, are "strict liability" offences. This means that the prosecution does not need to establish any elements of intention or fault with respect to the contravention. Where, however, the provision creating an offence does not provide that it is a strict liability offence, it will become necessary to consult the Code to see what the prosecution would need to prove in order to prosecute that offence.

It will be necessary for me to go into some detail about how the Code is intended to work. As a result of the *Criminal Code Amendment (Application) Act* 2000, the Code will apply to all offences against the law of the Commonwealth on and after 15 December 2001. I note, however, by virtue of section 769A of the Act (and see paragraph 6.115 of the Explanatory Memorandum) the Code will apply to all offences created by the Act from the time the Act becomes law. The *Criminal Code Act* 1995 originally contemplated that the Code applied to all Commonwealth offences from 15 March 2000. However, the deadline for implementation was extended in order to allow more time for Commonwealth offences to be "harmonised" with the Criminal Code. More about that in a moment.

As the name suggests, the purpose of the Criminal Code is "to codify the general principles of criminal responsibility under laws of the Commonwealth. It contains all the general principles of criminal responsibility that apply to any offence, irrespective of how the offence is created" (section 2.1). It follows that the "only offences against laws of the Commonwealth are those offences created by, or under the authority of, this Code or any other Act" (section 1.1). It will not surprise that by virtue of subsection 38(1) of the *Acts Interpretation Act* 1901 (Commonwealth), "Act" means an act passed by the Parliament of the Commonwealth. I cannot help mentioning here, without answering, the question whether but for the constitutional crisis that has led to the introduction of the *Corporations Act* 2001, whether it could be said, under existing arrangements, that a breach of the Corporations Law was an offence to which section 1.1 of the Code was capable of applying. It appears that certainly was the view of the Commonwealth Government and its advisers as one of the reasons for the need to extend the time for the application of the Code to all laws of the Commonwealth, was the need to amend the *Corporations Law* to make it "Criminal Code compliant".

The Explanatory Memorandum to the *Criminal Code Bill* 1994 described the coming of the *Criminal Code* as "the beginning of one of the most ambitious legal simplification programs ever attempted in Australia" (page 1).

The Explanatory Memorandum to the Code recognised the complexity and magnitude of the task ahead acknowledging, for example, that the Government would be taking a "staged approach" to the development of the Criminal Code". This was intended to "assist practitioners and courts to adjust to the changed approach and minimise confusion". The Code represents the culmination of work which began with the work of the Gibbs Committee and was continued by what became known as the Model Criminal Code Officers Committee of the Standing Committee of Attorneys-General. The Explanatory Memorandum describes the "new general principles of criminal responsibility" as representing "a unique blending of the two main approaches to the criminal law in Australia". That the Government had high expectations of the benefits that this Code would bring to the administration of criminal justice in Australia can be seen from the following passage in the Explanatory Memorandum:

> *Given constitutional differences, the Commonwealth Criminal Code will be different from the new state and territory criminal codes – its subject matter will include the existing Crimes Act 1914 and other serious offences. While this is the case, offences common to the Commonwealth and State Codes will be expressed in substantially the same terms and offences unique to the Commonwealth Criminal Code will be constructed having regard to the same principles of criminal responsibility. The benefit of this will be that no matter where a trial is held in Australia, offences will need to be proved in the same way. This will have enormous benefits in terms of simplifying joint commonwealth/state investigations and trials, the mobility of the legal profession and investigators and to Australian citizens as they do business or travel around the country. (page 2)*

The *Criminal Code* will indeed have the virtue of ensuring that the same principles for criminal responsibility will apply to all offences against the laws of the Commonwealth. At present, by virtue of the *Judiciary Act* 1903, the principles of criminal responsibility vary, and indeed may vary significantly, between jurisdictions. This means that a person accused of the same offence in one state may have a better chance of being acquitted than he or she would if the conduct had occurred in another State. As the Explanatory Memorandum notes, this is "difficult to justify".

Physical Elements

The Code introduces a new nomenclature for Australian federal criminal law inspired by existing common law and state *Criminal Code* concepts. Section 3.1(1) of the *Criminal Code* divides an offence into "physical elements" and "fault elements", which essentially replicate the common law concepts of "actus reus" and "mens rea".

For reasons which will become apparent, it is important for me to enumerate the permissible physical and fault elements of an offence. Section 4.1(1) of the Code provides that an offence may consist of one or more of the following physical elements:

- conduct;
- a circumstance in which conduct occurs; or
- a result of conduct.

"Conduct" means an act, an omission to perform an act or a state of affairs. Section 4.2 of the Code deals with the issue of the need for conduct to be voluntary, which I will not go into now. Section 4.3 deals with omissions. Notably, "omissions to perform an act can only be a physical element if:

(a) the law creating the offence makes it so; or

(b) the law creating the offence impliedly provides that the offence is committed by an omission to perform an act that by law there is a duty to perform."

While "circumstances" and "results" are fundamental aspects of the framework set up by the Code, unlike "conduct", neither concept is defined.

Fault Elements

Turning to mental elements or, as the Code requires, “fault” elements.

As with physical elements, the Code provides for the permissible “fault” elements providing, in section 5.1(1), that a fault element “for a particular physical element may be intention, knowledge, recklessness or negligence”. Importantly, particularly for the kinds of offences which are the subject of discussion in this paper, the Code expressly provides in section 5.1(2) that the denotation of permissible fault elements “does not prevent a law that creates a particular offence from specifying other fault elements for a physical element of that offence.”

The Explanatory Memorandum to the Code, however, does make clear that while Parliament may override the provisions relating to the general principles of criminal responsibility in the Code, “because of the fundamental nature of the principles of criminal responsibility, this should not be done lightly” and stating:

> *It is possible that subsequent legislation will vary the “general principles” in Chapter 2 in relation to specific offences. In the interests of the integrity of the scheme, variation should not occur without clear justification for it, and there are some principles that, because of the basic nature of the principles, it is difficult to imagine should be varied at all. Other principles might be susceptible to variation more readily, in particular, those dealing with the liability of corporations (proposed Part 2.5).(page 6)*

The Code definitions of these important concepts need to be reproduced in order to be able to highlight some of the issues with the market misconduct provisions.

> *Intention*
>
> 5.2
>
> (1) A person has intention with respect to conduct if he or she means to engage in that conduct.

(2) A person has intention with respect to a circumstance if he or she believes that it exists or will exist.

(3) A person has intention with respect to a result if he or she means to bring it about or is aware that it will occur in the ordinary course of events.

Knowledge

5.3

A person has knowledge of a circumstance or a result if he or she is aware that it exists or will exist in the ordinary course of events.

Recklessness

5.4

(1) A person is reckless with respect to a circumstance if:

(a) he or she is aware of a substantial risk that the circumstance exists or will exist; and

(b) having regard to the circumstances known to him or her, it is unjustifiable to take the risk.

(2) A person is reckless with respect to a result if:

(a) he or she is aware of a substantial risk that the result will occur; and

(b) having regard to the circumstances known to him or her, it is unjustifiable to take the risk.

(3) The question whether taking a risk is unjustifiable is one of fact.

(4) If recklessness is a fault element for a physical element of an offence, proof of intention, knowledge or recklessness will satisfy that fault element.

Negligence

5.5

A person is negligent with respect to a physical element of an offence if his or her conduct involves:

(a) such a great falling short of the standard of care that a reasonable person would exercise in the circumstances; and

(b) such a high risk that the physical element exists or will exist;

that the conduct merits criminal punishments for the offence.

Implications

The importance of understanding the key concepts of physical and fault elements appears from the following propositions mandated by the Code:

- If the law creating the offence does not specify a fault element for a physical element of an offence that consists only of conduct, intention is the fault element for that physical element (section 5.6(1)).
- If the law creating the offence does not specify a fault element for a physical element of an offence that consists of a circumstance or a result, recklessness is the fault element for that physical element (section 5.6(2)).
- If a law that creates an offence provides that the offence is an offence of strict liability, there are no fault elements for any of the physical elements of that offence and the defence of mistake of fact under section 9.2 is available (section 6.1 of the Code).

It follows from these fundamental propositions that:

(a) When analysing a law of the Commonwealth creating an offence, it is crucial to ascertain the fault elements and physical elements of the offence: from that analysis all else follows;

(b) Where an offence does not specify any fault element, and the offence by its terms does not say that it is “an offence of strict liability”, then the Code itself will imply the relevant fault element: fault elements so implied are called “default fault elements” – although this phrase will not be found in the *Criminal Code* itself, but can, for example, be found in paragraph 6.115 of the Explanatory Memorandum to the Bill:

> *"The Criminal Code will apply on commencement to all "offences based on" provisions in the proposed Chapter 7, that is, all offences created by the provision itself or created through the operation of sub section 1311(1) or section 1314 (continuing offences), (see proposed definition of "offence based on" (Item 250 of Schedule 1, Part 2)).* ***Therefore, in most instances the default fault elements specified in the Criminal Code of intention in relation to conduct and recklessness in relation to results or circumstances will be implied into offences."*** (Emphasis added).

(c) Where an offence is created by an existing law of the Commonwealth which does not appear to contain any mental element, and assuming a mental element need not be implied by reasoning of the kind illustrated by the High Court's analysis in *He Kaw Teh* (1985) 157 CLR 523, then that offence would be prosecutable without the prosecution having to establish any mental or, as the Code calls it, fault element. However, after 15 December 2001 such offences, by virtue of section 5.6 of the Code, will, unless in the meantime amended, attract the appropriate "default fault element": hence the need for a project to examine all laws of the Commonwealth which create offences to ensure that they are "Criminal Code compliant". Otherwise, in the words of the second reading speech by Senator the Honourable Amanda Vanstone, then Minister for Justice and Customs introducing the *Criminal Code Amendment (Application) Bill* 2000, "if many offences are not adjusted they will become more difficult for the prosecution to prove". This project has come to be known as "the harmonisation exercise" which has challenged Commonwealth officers over the last several years.

Corporate Criminal Responsibility

Before leaving this brief introduction to the *Criminal Code* itself, I must mention Part 2.5 of the Code which deals with the difficult area of attributing criminal responsibility to corporations.

Part 2.5, entitled "Corporate Criminal Responsibility", applies the Code to "bodies corporate in the same way as it applies to individuals. It so applies with such modifications as are set out in this Part, and with such modifications as are made necessary by the fact that criminal liability is being imposed on bodies corporate rather than individuals." (section 12.1(1)).

Part 2.5 of the *Criminal Code* introduces a concept of corporate criminal liability by reason of the existence of a "corporate culture" which facilitated a breach or failed to require compliance with a relevant provision (see sections 12.3(2)(c) and 12.3(2)(d) of the *Criminal Code*). "At common law, Australian corporate law principles have traditionally recognised the liability of corporations for criminal acts as being limited to those acts which could be traced to a sufficiently, highly placed functionary or group of functionaries within the corporation – the position established in England by the well known decision in *Tesco Supermarkets Limited v Nattrass*" (see Brand, "Legislating for Moral Propriety in Corporations? The Criminal Code Amendment (Bribery of Foreign Public Officials) Act 1999, (2000) 18 C&SLJ 476 at 479).

The Tesco approach to attributing corporate criminal responsibility has been the subject of considerable criticism. The Code is an attempt to deal with these issues and to introduce, as the Model Criminal Code Committee has argued, a concept of corporate culture which casts a "much more realistic net of responsibility over corporations than the unrealistically narrow Tesco test". The Explanatory Memorandum to the *Criminal Code Bill* provides that the liability provisions of the Criminal Code are intended to extend the Tesco rule so as to "catch situations where, despite formal documents appearing to require compliance, the reality was that non-compliance was expected" (page 44).

Under the *Criminal Code*, the fault elements of a criminal offence so far as they are to be attributed to a company can now be achieved if the company "expressly, tacitly or impliedly authorised or permitted the commission of the offence". Section 12.3(2) of the Code provides that the "means by which such an authorisation or permission may be established include:

(a) proving that the body corporate's board of directors intentionally, knowingly or recklessly carried out the relevant conduct, or expressly, tacitly or impliedly authorised or permitted the commission of the offence; or

(b) proving that a high managerial agent of the body corporate intentionally, knowingly or recklessly engaged in the relevant conduct, or expressly, tacitly or impliedly authorised or permitted the commission of the offence; or

(c) proving that a corporate culture existed within the body corporate that directed, encouraged, tolerated or led to non-compliance with the relevant provision; or

(d) proving that the body corporate failed to create and maintain a corporate culture that required compliance with the relevant provision.

Paragraph (2)(b) does not apply if the body corporate proves that it exercised due diligence to prevent the conduct, or the authorisation or permission.

Factors relevant to the application of paragraph (2)(c) or (d) include:

(a) whether authority to commit an offence of the same or a similar character had been given by a high managerial agent of the body corporate; and

(b) whether the employee, agent or officer of the body corporate who committed the offence believed on reasonable grounds, or entertained a reasonable expectation, that a high managerial agent of the body corporate would have authorised or permitted the commission of the offence.

"Corporate culture" means an attitude, policy, rule, course of conduct or practice existing within the body corporate generally or in the part of the body corporate in which the relevant activities takes place;

"High managerial agent' means an employee, agent or officer of the body corporate with duties of such responsibility that his or her conduct may fairly be assumed to represent the body corporate's policy.

I do not propose here to analyse in more depth some of the fascinating issues raised by Part 2.5 of the *Criminal Code*. Many of the concepts including, in particular, the notion of "corporate culture" are novel and untested. However, I submit that the position taken in the Act with respect to these issues is notable. Section 769A of the Act provides that except for Part 2.5, the *Criminal Code* "applies to all offences based on the provisions of the Chapter".

Curiously, in subsections 769B(1) to (3), the Government has chosen to reproduce the provisions contained in section 762 of the Corporations Act. The Explanatory Memorandum provides no explanation for this approach. The *Criminal Code* would otherwise be applicable to Chapter 7 of the Corporations Act. Curiously, Part 2.5 of the *Criminal Code* appears not to have been excluded from applying to the balance of the Corporations Act.

It is true that the Explanatory Memorandum to the *Criminal Code Bill* itself contemplates departure from the Code in dealing with the liability of corporations. The Explanatory Memorandum also says:

> *"This sets a basic standard of responsibility for bodies corporate in relation to general offences. It does not mean that the Commonwealth will not substitute other standards in relation to areas of law which require more stringent standards, such as laws regulating the behaviour of bodies corporate in relation to environmental matters."* (page 4)

and

> *"In cases where the degree of harm and difficulty of detection is a particular problem, a stricter basis of liability will be appropriate, such as now exists in manner Commonwealth offence provisions concerning corporations. It is not intended that Part 2.5 will become a new exclusive basis for corporate liability for Commonwealth offences."* (page 45)

However, it remains unclear as to why a different regime is being adopted in Chapter 7 of the *Corporations Act* in circumstances when the Code regime was intended to introduce a more effective approach to enforcing compliance against corporations using criminal sanctions.

CIVIL PENALTIES

Overview

The “financial services civil penalty provisions” represent, in my view, one of the most significant changes to the powers of the Australian Securities and Investments Commission (“ASIC”) since civil penalties for corporate misconduct were first introduced in 1993. The role of civil penalties generally, and in particular with respect to market misconduct, raises a number of fundamental issues, essentially arising from the mixed civil and criminal character of this remedy.

There is already a civil penalty regime in the *Corporations Act* in Part 9.4B. Under the Act, those provisions are known as the “corporation/scheme civil penalty provisions” while those in Part 7.10 are known as “financial services civil penalty provisions”.

The provisions of the Act constituting the civil penalty provisions, as the name implies, also form the basis of the civil liability provisions. However, it is important to stress, as the discussion above shows, that those provisions, without more, do not constitute all that is required to establish a breach for the purposes of a criminal prosecution. In other words, the mental or fault elements required to be established by the prosecution, but not by ASIC in a civil penalty application, are to be found by reading the Act and the Criminal Code together. In short, the civil penalty provisions are differentiated from the provisions creating criminal offences. The existing civil penalty regime achieves a similar outcome by, for example, in the case of insolvent trading, creating the civil penalty provision in *Corporations Act* section 588G(2) (read with section 1317E(1)(e)) while a prosecution for a breach of the insolvent trading provisions requires dishonesty to be established: see section 588G(3).

When the government foreshadowed the extension of the civil penalty regime to market misconduct, the move went largely unnoticed. Whilst civil penalties have been a feature of the *Corporations Act* since 1993, their use has been relatively infrequent although there have been a number of significant civil penalty applications brought by ASIC in the last 18 months. Commentators have had mixed views about the efficacy of civil penalties. One study questioned whether the existence of the civil penalty regime has had any impact at all in connection with the enforcement of the director's duties provisions of the *Corporations Act*.

The rationale for the existence of civil penalties lies in the flexibility they provide and, in theoretical terms, where they notionally sit in the enforcement spectrum. "The argument for a cogent structure of cumulative sanctions incorporating civil remedies at the base, criminal sanctions at the apex and civil penalties filling the middle ground, is compelling" (see Goldwasser, "CLERP6 – Implications and Ramifications for the Regulation of Australian Financial Markets" (1999) 17 C&SLJ at page 210).

However, there are many issues raised by the civil penalty provisions. Essentially, whether or not there ought to be a role for civil penalties at all on the basis that in Australia there is, in effect, no "middle ground" between civil and criminal remedies. This view sees a fundamental distinction between the purposes of the criminal law, and the procedure by which it achieves its objectives, on the one hand and the compensatory function, and the procedures by which that objective is achieved, on the other. This view holds that there ought not to be any blurring of the two paradigms. Some commentators consider that it is an inappropriate function of a court exercising civil jurisdiction to be given the power to impose punishment, without the procedural and other safeguards of the criminal justice system. There is indeed a blurring of the two approaches and this is reflected in what might be described as parliamentary ambivalence when the civil penalty provisions themselves are examined. For example, see how sections 1317M to 1317Q of the Corporations Act attempt to resolve issues arising out of the parallel conduct of civil penalty and criminal proceedings.

For example, while these penalties are described as "civil" a court is not empowered to impose a civil penalty without first being satisfied that the contravention will "materially prejudice" the interests of acquirers, disposers or the issuer of a financial product to which it relates or be “serious” (see section 1317G(1A)(c)). While the existing Corporations Act requires that applications of this kind be heard in accordance with the civil rules of evidence and procedure (see section 1317L), the Australian case law has accepted that defendants cannot generally be required to give discovery or necessarily file a full defence. The civil burden of proof, however, is the accepted standard (see *Corporations Act* section 1332) although with due regard to the gravity of the allegations to be established.

As the legislative history of these provisions shows, different approaches have been taken so far as the significance of bringing a civil penalty application for any subsequent or parallel criminal proceedings.

When the civil penalty regime was first introduced in 1993, the bringing by the regulator of an application for the imposition of a civil penalty acted as a bar to any criminal proceedings over the same subject matter. Subsequently, this position has changed so that the bringing of the application would not without more act as a bar to subsequent or parallel criminal proceedings.

One of the issues is what role for the DPP in the civil penalty decision making process do these provisions suggest? In practice, there is consultation between the DPP and ASIC with respect to whether or not to bring civil penalty applications in particular cases.

Initially, the rationale for the consultation lay in the fact that the bringing of an application would bar forever the bringing of any criminal proceedings and, so it was argued, this was tantamount to making a prosecution decision.

The prosecution policy of the Commonwealth does require the Director to take into account “the availability and efficacy of any alternatives to prosecution” (see paragraph 2.10(j) of the Policy).

Market misconduct and civil penalties

The arrival of civil penalties under the Act for market misconduct raises the stakes for failing to comply with the insider trading, market manipulation and continuous disclosure provisions.

The existing framework in relation to market misconduct drives ASIC in one direction. If ASIC cannot establish a case to a criminal standard (the decision to prosecute is ultimately made by the Commonwealth Director of Public Prosecutions), then no punitive action at all is open. This complex and subtle area often reveals abuses which call for responses that the criminal justice system is not equipped to deal with. The civil penalty option will make it easier for ASIC to force corporations and their officers into Court. Defendants will face significant pecuniary penalties, but not jail. For the first time, the Court will itself have the opportunity to scrutinise the provisions in question and publish its conclusions.

MARKET MANIPULATION

Overview

The law relating to market manipulation is particularly difficult. The central problem of regulation of stock market manipulation is being able to distinguish, in particular fact situations, genuine transactions from those that are "artificial". Vivien Goldwasser, in her book Stock Market Manipulation and Short Selling (1999) extensively canvasses the issues. I do not propose here to examine the case law in particular, the High Court's decision in *North v. Marra Developments Limited* (1981) 140 CLR 42, and the decision of Sackville J in *Australian Securities Commission v. Nomura International plc* (1998) 29 ACSR 473.

Dr Goldwasser has observed that "there are serious deficiencies in the formulation" of the relevant anti-manipulation sections of the Corporations Law themselves "in particular the central but problematic issue of manipulative intent". Moreover, as Dr Goldwasser's analysis shows, the existing *Corporations Act* provisions involve a mixture of subjective and objective elements to establish the manipulative nature of a particular transaction or transactions.

The market manipulation and related provisions are comprised of a general market manipulation provision (section 1041A); false trading and market rigging – creating a false or misleading appearance of active trading, etc (section 1041B) and false trading and market rigging – artificially maintaining, etc, trading price (section 1041C). These provisions are principally based on the provisions formerly found in Part 8.7 Division 2 of the *Corporations Act* dealing with futures rather than upon existing Part 7.11 dealing with conduct in relation to securities.

Market manipulation: section 1041A

The principal market manipulation provision, section 1041A, does not contain any fault elements. It will therefore be necessary to apply the default fault elements implied by the *Criminal Code*. In this instance, it will be necessary for the prosecution to prove:

(a) that the person in question intentionally entered into the transactions described in paragraphs (a) and (b) of the section within the meaning of the Code; and

(b) more interestingly, if the outlawed "effects" described in sub-paragraphs (c) and (d) of that provision, are properly characterised as "results" within the meaning of the *Criminal Code*, then the relevant default fault element is as follows:

> *If the law creating the offence does not specify a fault element for a physical element that consists of a circumstance or a result, recklessness is the fault element for that physical element. (section 5.6(2))*

Notably, subsection 5.4(4) of the Code provides that if "recklessness" is a fault element of an offence, then "proof of intention, knowledge or recklessness will satisfy that fault element". This does seem a confusing approach to identifying what the prosecution is required to prove. Section 1041A replaces sections 997 and 1259 of the *Corporations Act*. However, the offences presently found in subsections (4) and (7) of s.997 are not reproduced.

In her book, Dr Goldwasser makes the point that, among other things, the section 1259 formulation in the *Corporations Act* (dealing with futures) "is a distinct improvement over the section 997 formulation" as it contemplates the fact of a single manipulative transaction. Furthermore, citing John Currie's book (Australian Futures Regulation, 1994 at page 224), intent is not a necessary element of the section 1259 offence:

> *Paragraphs (a) and (b) of the section make it quite clear that the results described in paragraphs (c) and (d) [relating to the creation and maintenance of an artificial price] must either have been intended or, on a completely objective test, have been the likely effects of the transactions … there is nothing in the section nor in any interpretation provision to support a subjective gloss on the phrase "likely to have the effect".*

This is one example, in my view, of how the *Criminal Code* will materially affect the approach to construction of these provisions. The Explanatory Memorandum to the Act does not go into any detail at all about what Parliament intended by these provisions, save to say that they are all based on existing provisions of the *Corporations Act*. However, it does seem that the overlay of the *Criminal Code* will introduce many new questions of construction. Other legal consequences of basing section 1041A principally on section 1259 of the *Corporations Act* is a recognition now that manipulation can occur through one transaction, rather than only two or more (see section 997(1)) and, rather than using concepts of price reduction or stabilisation, the key concept in the section is now whether a price is "artificial". It will be seen that close textual analysis of existing provisions 997 and 1259 will reveal subtle differences of approach. Whether this will lead to significant changes in substance, in situations of daily significance to industry, will require further analysis in light of experience and case law.

False trading and market rigging – creating a false or misleading appearance of active trading (section 1041B); artificially maintaining, etc, trading price (section 1041C)

Sections 1041B and 1041C, according to the Explanatory Memorandum, are intended to replace sections 998 and 1260 of the *Corporations Act*, be "based on section 1260", "but applying to all financial products traded on a financial market" (see paragraph 15.14). As with section 1041A, market manipulation, the word "effect" is used so that if the trading in question creates, or causes the creation of, a false or misleading appearance of active trading in a financial product or with respect to the market for, or the price for trading in, a financial product, then for *Criminal Code* purposes, these would be "results".

The "wash trading" provisions of sub-paragraphs (2), (3) and (4) of this section however, pose some difficulties of construction. Sub-section (2) provides that a person "is taken to have created a false or misleading appearance of active trading" where there has been no change in beneficial ownership (see subsections 1041B(2)(a) and (3)). How is this provision to be treated in a prosecution? Are the physical elements of this offence provided for by section 1041B(2)(a) taken to be "circumstances" within the meaning of the *Criminal Code* leading to the imposition of the default fault element with respect to a circumstance: a person has intention with respect to a circumstance if he or she believes that it exists or will exist" (*Criminal Code* section 5.2(2)). However, in accordance with the provisions of 5.6(2) the *Criminal Code,* as the law creating the offence does not specify a fault element or a physical element of an offence that consists of a circumstance or a result, as here, "recklessness is the fault element for that physical element". A person is reckless with respect to a result if he or she is aware of a substantial risk that the result will occur and having regard to the circumstances known to him or her, it is unjustifiable to take the risk. (see section 5.4(2) of the *Criminal Code* – see also section 5.4(4) referred to above).

For completeness, I note that the Code does deal with the use of "averments". An averment permits the prosecutor to allege matters of fact in an information or complaint. The averment amounts to <u>prima facie</u> evidence of the matters averred. The drafters of the Code, as a matter of policy, did not favour averments. Section 13.6 of the Code provides:

> *A law that allows the prosecution to make an averment is taken not to allow the prosecution:*
>
> *(a) to aver any fault element of an offence; or*
>
> *(b) to make an averment in prosecuting for an offence that is directly punishable by imprisonment.*

However, the Explanatory Memorandum to the Act at paragraph 15.15, seems to suggest otherwise by saying that "the deeming provision in subsections 998(5) and 998(7) that provides an example of what constitutes creating a "false or misleading appearance" will be retained in proposed section 1041B".

In my view therefore, there may be difficulties in the operation of the "deeming provision" contained in s 1041B in view of the effect of section 13.6 of the *Criminal Code*. The position may be otherwise when the provision is the subject of civil proceedings, for example, for the imposition of a civil penalty.

Notably, existing section 998(8) of the *Corporations Act* provides for the following defence:

> *"In a prosecution for a contravention of sub-section (3) in relation to a purchase or sale of securities that did not involve a change in the beneficial ownership of those securities, it is a defence if it is proved that the purpose or purposes for which the securities were bought or sold was not, or did not include, the purpose of creating a false or misleading appearance with respect to the market for, or the price of, securities."*

That defence does not appear to have been reproduced in the Act and is not the subject of comment in the Explanatory Memorandum. Perhaps it was thought that the effect of section 13.6 of the Code would mitigate the otherwise harsh effect of sub sections 1041(B)(2)(a) and (3), and not requiring the retention of any special defence of the kind found in section 998(8)? Part 8.7 Division 2 of the *Corporations Act* does not presently provide for this defence (see section 1260). Section 1260(3) does, however, provide that in "determining whether a transaction is fictitious or artificial for the purposes of sub-section (2), the fact that the transaction is, or was at any time, intended by the parties who entered into it to have effect according to its terms is not conclusive".

Before leaving this section, mention needs to be made of some late amendments dealt with in a Supplementary Explanatory Memorandum. Paragraph 3.115 of the Supplementary

Explanatory Memorandum provides that subsection 1041C(1) was altered "to clarify the existing physical elements in the offence provisions relating to false trading and market rigging". This objective appears to have been achieved by inserting the phrase "results in". I take it from the objective for this parliamentary amendment that its rationale is related to a concern about the application of the *Criminal Code*. However, that would be speculation.

GENERAL MARKET MISCONDUCT PROVISIONS

Overview

These provisions comprise dissemination of information about illegal transactions (section 1041D); false or misleading statements (section 1041E); inducing persons to deal (section 1041F); an entirely new section dealing with dishonest conduct (section 1041G) and a general prohibition on misleading or deceptive conduct – civil liability only (section 1041H). I have not sought to tease out all of the fault elements required by the *Criminal Code*. However, perhaps the most interesting feature of this part of the Act is the introduction of a definition of dishonesty. Otherwise, most of the provisions are generally based on existing provisions of the *Corporations Act*.

Dissemination of information about illegal transactions: section 1041D

This provision substantially reflects current provisions of the *Corporations Act* dealing with securities (section 1001) and futures (section 1263). The language of section 1041D more closely resembles existing provision 1263. Section 1041D utilises the concept of "be involved in", not directly replicated in section 1001 but substantially reproduced in existing section 1263 when it uses the expression "authorises or is concerned in".

False or misleading statements: section 1041E

This provision replaces sections 999 and 1261 of the *Corporations Act*, however the language deployed reflects section 999 more than section 1261.

Inducing persons to deal: section 1041F

This provision replaces sections 1000 and 1262 of the *Corporations Act*. Like section 1041E, this provision is not a civil penalty provision but does lead to civil liability if breached. Notably, and this is developed further below, the section contains a definition of dishonesty.

Other notable features of this provision include the introduction of the concept of recklessness in section 1041F(1)(a) and the removal of the defence presently provided in subsections 1000(3) and 1262(7) of the *Corporations Act*. Presently, it is for the defence to prove that he or she had reasonable grounds for the belief underpinning the defence. Under proposed section 1041F, it is for the prosecution to establish what the defendant's belief was at the material time (see section 1041F(1)(c)(ii)). Presumably, although it is not stated in the explanatory memorandum, this was done in order to make the provision *Criminal Code* compliant.

I note that paragraph 3.116 of the Supplementary Explanatory Memorandum says that section 1041F extends the coverage of the prohibition to encompass the following conduct: applying to become a standard employer sponsor of a superannuation entity, permitting a person to become a standard employer sponsor of a superannuation entity and applying on behalf of an employee for the employee to become the holder of an RSA product. See subsection 1041F(3).

Dishonest conduct: section 1041G

Section 1041G of the Act is a completely new provision, without any direct equivalent in the current *Corporations Act* framework. The section will prohibit people, in the course of carrying on a financial services business, engaging in dishonest conduct in relation to a financial product or service. In addition to a contravention of the provision leading to criminal consequences, the Explanatory Memorandum (paragraph 15.19) says that it is also a civil penalty provision. This appears to be a mistake, reference probably being intended to be made to section 1041I which provides for persons who suffer loss or damage "by conduct of another person that was engaged in in contravention of section 1041E, 1041F, 1041G or 1041H may recover the amount of the loss or damage by action against that other person or against any person involved in the contravention, whether or not that other person or any person involved in the contravention had been convicted of an offence in respect of the contravention". Section 1041I(4) will apply existing Corporations Act section 1317S (providing for relief from liability for contravention of a civil penalty provision), as if sections 1041E, 1041F, 1041G or 1041H were civil penalty provisions.

The other feature of this provision, which is not the subject of any amplification in the Explanatory Memorandum, is the inclusion, so far as I can tell for the first time in the *Corporations Act*, of a definition of "dishonest". For the purposes of proposed sections 1041F (inducing persons to deal in financial products by, among other things "dishonest concealment of material facts") and 1041G, dishonest means:

(a) dishonest according to the standards of ordinary people; and

(b) known by the person to be dishonest according to the standards of ordinary people.

The definition of dishonesty has both an objective and a subjective limb. The prosecution must first show that the conduct is dishonest according to the standards of ordinary people and then that the alleged offender knew that the conduct was so regarded. This seems to be a codification of the test developed in *Ghosh* [1982] Q.B. 341, which held that dishonesty required the jury to find both that what was done was dishonest according to the ordinary standards of reasonable people and that the defendant must have realised that what he was doing was dishonest according to those standards. However, the appropriate test for dishonesty for *Corporations Act* purposes generally raises many complex issues. See, for example, the different approaches taken by the High Court to the concept of dishonesty in *Peters* (1998) 192 CLR 493. It will be interesting to see whether the government decides to adopt this test of dishonesty for Corporations Act purposes generally. For example, important provisions such as section 184(1)(b) (a director or officer of the corporation commits an offence "if they are intentionally dishonest; and fail to exercise their powers and discharge their duties …") and section 588G(3)(d) (providing that the offence of insolvent trading requires, among other things, the prosecution to show that "the person's failure to prevent the company incurring the debt was dishonest").

Misleading or deceptive conduct (civil liability only): section 1041H

This is a general prohibition on conduct, in relation to a financial product or a financial service, that is misleading or deceptive or is likely to mislead or deceive. The Explanatory Memorandum (see paragraphs 15.8 to 15.10) says that the provision replaces section 995 of the *Corporations Act*. In keeping with the structural approach adopted in the *Corporations Act*, the new provision will not apply to misleading or deceptive takeover, compulsory acquisition and fundraising documents or disclosure documents or statements as defined in Parts 7.7 and 7.9 of the Act. Chapters 6B and 6D of the *Corporations Act*, together with Parts 7.7 and 7.9, provide self-contained liability regimes for these types of documents (subsection 1041H(2), see paragraph 15.10 of the Explanatory Memorandum). "The application of a misleading and deceptive conduct requirement in these circumstances would defeat the specific defences included in these regimes such as, for example, the due diligence defence in section 731 of Chapter 6D".

Paragraph 3.117 of the Supplementary Explanatory Memorandum explains a parliamentary amendment which ensures that provisions relating to misleading or deceptive conduct apply to the following: applying to become a standard employer sponsor of a superannuation entity; permitting a person to become a standard employer sponsor of a superannuation entity; a trustee of a superannuation entity dealing with the beneficiary of that entity as such beneficiary; the trustee of a superannuation entity dealing with a standard employer sponsor; applying on behalf of an employee for an RSA product; an RSA provider dealing with an employer who applies on behalf of an employee for an RSA product; or carrying on negotiations or doing any act preparatory to any of the above.

Paragraph 3.118 of the Supplementary Explanatory Memorandum explains the "purpose of these amendments is to ensure that the current prohibitions against misleading or deceptive conduct contained in the *SIS Act* and the *RSA Act* are carried over to the proposed *Corporations Act*".

INSIDER TRADING

Overview

While not highlighted by the Explanatory Memorandum, there have been some interesting changes in the insider trading provisions found in Division 3 of Part 7.10 of the Act. As it happens, the Companies and Securities Advisory Committee ("CASAC") has recently released its discussion paper on insider trading where some 40 issues are identified for discussion and potential law reform. I set out only some of the issues below, essentially arising from the attempt to base Division 3 on existing provisions of the Corporations Act dealing with securities (Division 2A of Part 7.11) and futures (see Division 1 of Part 8.7). Some of the more significant changes or issues arise out of the attempt to make the provisions *Criminal Code* compliant and the extension of them to "derivatives" but not based on the features of existing Division 1 Part 8.7, but rather based on the approach presently taken with securities (for example, with respect to the question of whether a person needs to be "connected" to the body corporate before being capable of committing the offence of insider trading over a derivative).

The "knowledge test" and "possession": some issues

While the Explanatory Memorandum largely glosses over the issues raised by the need to divine the fault elements in the market misconduct provisions by reference to the *Criminal Code*, suggesting, at least, that there is no change of substance that is noteworthy, in the area of insider trading, a different approach has been taken. As it happens, the Government has decided to restore the status quo on the critical issue of knowledge as the following discussion shows.

At first, the explanatory memorandum had this to say in paragraph 15.23 about the issue:

> *15.23 The proposed provisions are Criminal Code compliant, which has required amendments to the fault elements that are contained in proposed section 1043A. This has generally required replacing the concept of 'knows or ought reasonably to know' in current section 1002G with the concept of knowledge or recklessness. This*

> *subjective fault element is more appropriate to a serious offence carrying a maximum penalty of five years imprisonment and will promote certainty in the operation of the offence. It will apply to any person who is aware of a substantial risk of the relevant matter (see definition of 'recklessness' in the Criminal Code), whereas previously it was necessary to demonstrate either that the defendant had actual knowledge or that they ought reasonably to have had actual knowledge.*

Curiously, and unlike the balance of the market misconduct provisions, the insider trading provisions are singled out as being "criminal code compliant". As the Explanatory Memorandum says, the concept of "knows or reasonably to know" in current section 1002G has been dropped. It is unclear why this has occurred other than to assert its appropriateness. That indeed might still be correct, however, it is respectfully submitted that this conclusion is not required by the *Criminal Code* and, consequently, not required to make these provisions "criminal code compliant". This is because the *Criminal Code* itself contemplates that an alternative fault element is permissible in the law creating the particular offence (see *Criminal Code* section 5.1(2) where the Code itself gives the example of the fault element for the offence of judicial corruption under section 32 of the *Crimes Act* 1914 where the relevant conduct is to be carried out "corruptly").

It is unclear from the Explanatory Memorandum what reasons of policy, if it is accepted that the *Criminal Code* cannot be relied upon for this purpose, that led to a stricter fault element being introduced into the insider trading provisions which will make the task of the prosecution more difficult. This outcome appears to have been attempted without regard to the history of the development of these provisions and the fact that CASAC was about to publish a discussion paper on the current insider trading provisions.

Another aspect of the insider trading provisions is the question of possession. While knowledge (see section 1043A(1)(b) of the Act) provides for fault elements, as set out above, so far as possession of the price sensitive information is concerned, the provision is silent. As possession of the information by a person is a physical element of the offence, it becomes important to determine whether possession, for the purposes of the provision, is "conduct", a "circumstance in which conduct occurs" or "a result of conduct".

It is not immediately apparent how this element of the offence of insider trading, possession of information, is to be characterised for *Criminal Code* purposes. If possession of information is to be "conduct", then the relevant default element is therefore "intention". "Intention with respect to conduct" means that the person meant to do the conduct – a concept with respect to possession of information which appears incongruous. Is possession a "circumstance"? If so, then recklessness is the default fault element for that physical element. Again, that does appear to be incongruous with respect to insider trading.

For practical purposes, it might be thought that possession is bound up with the mental or fault elements required for knowledge: however, as no fault element is specified, the Code compels resort to default fault elements.

Possession is quite a separate concept from knowledge in the insider trading provisions together with the other physical elements (information not generally available, acquisition by person of the financial product in question), raises, in my view, needlessly, issues with respect to the appropriate fault element that is required by the *Criminal Code*.

Curiously, the foregoing discussion has, largely, been overtaken by parliamentary amendments explained in paragraph 3.119 of the Supplementary Explanatory Memorandum as follows:

Proposed item 135 clarifies the nature and application of the physical and fault elements in the prohibition against insider trading in proposed section 1043A. The amendments provide that the fault element for the physical element in paragraph (1)(a) is contained in paragraph (1)(b), similarly that the fault element for the physical element in paragraph (2)(a) is contained in paragraph (2)(b). This will ensure that the application of a Commonwealth Criminal Code does not produce any unintended changes to the interpretation of the provision. The amendments also reinstate the objective fault element of "ought reasonably to know" in paragraphs (1)(b) and (2)(b) that currently applies to this offence.

Again, no explanation is given as to why insider trading, among all the market misconduct provisions, requires special provision for application of the *Criminal Code* in order to avoid "unintended changes".

The *Firns* appeal and the problem of "readily observable matter"

On 21 May 2001, the New South Wales Court of Criminal Appeal in *Firns* [2001] NSW CCA 191 dealt with the construction of "readily observable matter" in section 1002B(2)(a) of the *Corporations Act* (reproduced in proposed section 1042C(1)(a) of the Bill). The following summary of the facts is taken from the judgment of Mason P, who wrote the majority judgment, Carruthers AJ dissenting.

Carpenter Pacific Resources NL was a company incorporated in Australia whose shares were listed on the ASX. In 1995 its main business was the holding of exploration licences in Papua New Guinea, primarily through wholly owned subsidiaries. There were two Carpenter directors who had executive functions at the relevant time. The chairman and company secretary was Mr Richard Hill and the other executive director was Mr Ron Firns, the appellant's father. In 1995, Carpenter's full time general manager in Papua New Guinea was Mr James Kruse. (Mr Kruse was acquitted in a related insider trading prosecution, discussed below). One of Carpenter's subsidiaries was Matu Mining Pty Ltd, a company registered in Papua New Guinea. Matu held an exploration licence over a large area in Papua New Guinea thought to have prospects of gold. In December 1993, the Papua New Guinea Government made the Mining (Transitional Provisions) Regulation 1993, purportedly pursuant to the Mining Act 1992. The effect of the regulation was to divest Matu of a valuable incident of its exploration licence. The regulation was obviously adverse to Carpenter's interest, because it effectively removed Carpenter's right to explore for gold in part of the area covered by its exploration licence. Matu challenged the validity of the regulation and the National Court of Papua New Guinea. The challenge was dismissed in March 1994. Matu appealed to the Supreme Court of Papua New Guinea. The appeal was heard in October 1994, in open court, and judgment was reserved.

On the evening of 27 July 1995, the Supreme Court indicated that judgment would be handed down the following day in Port Moresby at 9.30 am. This came to the attention of Carpenter's officers in Port Moresby and Sydney. This notification was not the information upon which the prosecution was based. Judgment was handed down at about 9.30 am on Friday, 28 July. The appeal was upheld and the regulation declared invalid. Mr Kruse was present in open court when the judgment was delivered. So too was a solicitor from the firm of solicitors representing Matu/Carpenter in Papua New Guinea. Newspaper reporters and landowners from the affected area were also present. The time zone in Port Moresby was the same as in Sydney. At about 9.40 am, the good news was phoned through to Mr Hill in Sydney, who then informed Mr Firns Snr. Mr Firns Snr then telephoned the news to his son (the appellant) in Brisbane at about 10.08 am.

It was in these circumstances that both Messrs Kruse and Firns purchased shares in Carpenter later that morning. A notification to the ASX was not finalised until later that day and sent to the ASX the following Monday morning. The Crown alleged that the information about the Papua New Guinea judgment was information that was not generally available until after the ASX was first notified, which was about 1.30 pm on Friday, 28 July 1995. That notification was made at the Perth branch of the ASX by an unrelated company interested in the judgment. By that stage, the purchases by Messrs Firns and Kruse had been effected. Newspaper reports of the decision of the Supreme Court of Papua New Guinea first appeared in Papua New Guinea on 31 July 1995 and Australia on 1 August 1995.

The critical issue on the appeal was whether or not the judgment of the Papua New Guinea court was generally available information at the time of the share purchases in question. It was not in issue that the favourable court outcome would have a material effect on the price of the Carpenter shares and that this information was known to Messrs Kruse and Firns prior to it being the subject of notification to the ASX.

Messrs Kruse and Firns were separately tried. Mason P observed that the acquittal of Mr Kruse and the conviction of Mr Firns “cannot be reconciled on the facts”.

Mr Kruse was acquitted by direction of O’Reilly DCJ, who held that what happened in the Supreme Court at 9.30 am was in the “public arena” and therefore constitute “readily observable matter". He concluded that the facts had to be directly observable in a public arena, but that the public arena did not need to be confined to Australia or to any state in Australia. It was sufficient that the arena was "public" in the Shorter Oxford Dictionary sense of being "open to general observation, existing, done or made in public, manifest, not concealed".

I do not propose to recount here Mason P's review of the rationale for the prohibition against insider trading and the legislative history. Mason P held (Hidden J agreeing) that, although his construction of section 1002B(2)(a) "produces a problematic outcome in the present case", he considered that was "a product of the concept of ready observability chosen by the Legislature". Mason P held that the information did not need to be readily observable by someone in Australia and that it was not open to him, as a judge, to imply the presence of words such as "in Australia", "by a person in Australia", or "by a member of the public in Australia".

His Honour adverted (at para. 81) to the internet:

> *"There is a further difficulty with the direction that ready observability is to be tested from the stance of a hypothetical person "within Australia". I have already touched upon it. The direction suggests or infers that the* ***readiness*** *of the perceptibility is also to be judged from the viewpoint of individuals located in Australia using their natural senses but without regard to modern methods of telecommunication. The unelaborated direction referred to "those in Australia" carries the seeds of miscarriage when it is recognised that television, the internet (including e-mail) and other means of telecommunication such as the phone and fax are part and parcel of how Australians generally and investors in particular readily perceive events."*

Mason P was also particularly influenced by the fundamental principles of open justice. Mason P observed (at para 91):

"The requirement that courts sit in public and render themselves accountable through delivery of reasoned judgments proceeds from an assumption that that which happens in open court is capable of reportage to the whole world because it is observable. A published judgment of the highest appellate court in a country is readily observable in every circumstance that I can conceive of. The Crown submitted that a judgment of the High Court of Australia would not necessarily constitute "readily observable matter". It would depend on the notoriety of the issues involved … I disagree. In its present form, paragraph (a) of section 1002B(2) does not turn upon the readiness with which information may be disseminated or absorbed."

Mason P reviewed the Griffiths Committee Report and the explanatory memorandum explaining the drafting of section 1002B, concluding (at paras 57 and 58):

"Both the Committee and Parliament were concerned not to "penalise individual initiative and diligence" (Committee Report at §4.5.8). However, both Committee and Parliament rejected a bright line definition. And Parliament went further in recognising that, for some types of information, cleverness, swiftness and efficiency are to be encouraged. The Committee's call for drafting clarity was also ignored with the insertion of the opaque words "readily observable matter".

*These policy and drafting decisions left the courts with a difficult interpretative task. The task is focussed by provisions requiring the Court to give effect to legislative purpose and permitting recourse to extrinsic material (***Corporations Law***, ss109H, 109J), but the assistance is blurred by the conflicting goals embedded in the essentially two-pronged definition of "information generally available"."*

It is instructive to refer also to the strong dissenting judgment of Carruthers AJ, who agreed with the Crown's submission that, for information to be generally available on the basis that it consists of readily observable matter, "it must, at least, be readily observable by members of the Australian public", as the provisions contained in the *Corporations Law* "are clearly designed principally to protect Australian investors by promoting equal access to information for investors". His Honour held (at paras 119 and 120):

> *"I cannot accept, as the appellant contends, that the Legislature has inadvertently overlooked that information may be readily observable but not readily observable in Australia. Such a construction would defeat the purposes of the Act. There could be no rational possibility of an oversight on the part of the Legislature in this regard."*

In support of the appellant's argument, reliance was (as one would expect) placed upon the facility and speed with which commercial information can be transmitted throughout the world, even from relatively remote areas; one of the most effective means of communication now being, of course, the World Wide Web. One might add, parenthetically, that there was no evidence that the PNG Supreme Court judgment was at any stage posted on the World Wide Web.

The capacity of the internet to both make available and to instantly disseminate very broadly price sensitive information raises very difficult issues for legislators and regulators. Also, as the following passage from Mason P's judgment shows, the complexity of the area raises challenges for legislators to ensure that careful thought is given to the ultimate form legislation takes to give effect to often competing policy considerations (para 53):

> *"The language of the statutory definition of "generally available" and the drafting history of that definition demonstrate that the Griffiths Committee's clear vision of an underlying policy of promoting fairness in the market through equal access to information became badly blurred in the legislative process. This did not happen through oversight, although it is possible that different participants in the legislative process concentrated on one factor to the exclusion of the other or persuaded themselves that two essentially conflicting policies could be brought into sharp focus at the point of statutory definition. Regrettably for the courts at least, this has not happened. The result has been a form of legislated astigmatism because the attempt to converge essentially incompatible policy goals has produced a patchy blurring of the*

image (cf definition of astigmatism in ***Penguin New English Dictionary****: "a defect of an optical system, eg a lens of the eye, in which rays from a single point fail to meet in a focal point, resulting in patchy blurring of the image".)"*

These issues still await a legislative solution. One thing is clear, the current insider trading provisions cannot remain in their current form. The issue is the subject of a very helpful discussion in the CASAC paper on insider trading (see paragraph 2.14 and following).

Financial products covered by the definition

This issue is dealt with in the CASAC insider trading paper (see paragraph 2.85 and following). The Explanatory Memorandum is silent on the point. Currently, the insider trading provisions only cover securities (including interests in managed investment schemes) and futures contracts (see Division 1, Part 8.7 of the *Corporations Act*). The Act defines financial products, for the purposes of the insider trading provisions, as "Division 3 financial products" essentially covering these products as well as other derivatives, superannuation products, and any other financial products that can be traded on a financial market (see section 1042A).

At the moment, by virtue of the definition of futures contract in section 1251, the insider trading provisions only extend to futures contracts over securities. An issue arises as to whether the insider trading provisions should be extended to exchange traded derivatives over commodities. This issue has previously been the subject of CASAC's attention in its Advisory Committee Report Regulation of On Exchange and OTC Derivatives Markets (1997 at paragraph 8.52 and following). The Act appears to accept the principle that the insider trading provisions "should apply to derivatives over commodities, albeit that it may be relatively rare for individuals to hold confidential price-sensitive information that would materially affect a particular commodities market" (Insider Trading Discussion Paper paragraph 2.90).

As things presently stand, issue 12 identified by CASAC as follows, appears to have been resolved in favour of not accepting the first part of recommendation 46 in CASAC's June 1997 report (see page 197):

Should the range of financial products covered by the insider trading provisions of the Financial Services Reform Bill exclude indices, derivatives over commodities and/or any other financial products?

CONTINUOUS DISCLOSURE

The most notable feature of the continuous disclosure provisions, to be found in Chapter 6CA, and perhaps of most current interest, is the extension to them of the civil penalty regime. There has not been a single criminal prosecution for a contravention of the continuous disclosure provisions since they were introduced in 1994. While ASIC has, with the ASX , adopted a variety of strategies to enforce the continuous disclosure regime, experience with the Commonwealth Director of Public Prosecutions has shown the difficulties of establishing that a failure to disclose price sensitive information was intentional or reckless to the requisite criminal standard. This has left ASIC and the ASX in a difficult position. Often, as a result of ASIC or ASX intervention, a corporation will be forced to disclose information which it would not have otherwise disclosed at all or would not have disclosed as promptly as it was required to do. However, while the disclosure that was required was ultimately achieved, there were still regulatory and community expectations that a breach would attract some form of punitive response. In the absence of a viable criminal remedy, as the law presently stands, there is no other remedy that effectively deals with this issue. The *Corporations Act* does contemplate recovery of damages by persons who can show they suffered a loss as a result of a breach of provisions of this kind. Again, however, legal and practical concerns make actions for the recovery of damages impracticable. The harm involved is really sustained by the market as a whole. Individual claims may not only be difficult to quantify but, individually, may not justify the costs and risks associated with litigation to recover them. In the meantime, there is no case law interpreting the provisions and corporations with poor disclosure track records go unpunished.

CONCLUSION

Rather than making clear what the fault elements were in the markets misconduct provisions so as to have the practical and legal effect of excluding consideration of the *Criminal Code* for that purpose, readers of the Act will, in many instances, be in effect left to speculate about what the appropriate fault elements are when characterisation of the physical elements of the offence is not entirely clear. It does not appear that the drafters of the Act intend any substantial change from existing law (other than those that are noted in the Explanatory Memorandum). However, whether that is in fact so awaits further analysis and experience.

There is much in the Act that represents new approaches to regulation of market misconduct. All will be challenged by the novelty of the concepts introduced by the *Criminal Code*. Civil penalties will create significant new opportunities for ASIC to deal with a range of misconduct, particularly in the area of continuous disclosure.

For lawyers, great care will need to be taken to identify the legislative strand which supports a particular conclusion. For industry, while much of the substance of the regulatory approach presently found in the Corporations Act is intended to be reproduced in Chapter 7, the attempt to take a unified approach to regulating financial products generally will, I think, force industry to reconsider its compliance strategies as regulatory and market attention is, in effect, refocussed on a range of financial products that historically may not have been regarded as being relevant to market manipulation and insider trading, for example.

8October 2001