Insider trading and market manipulation

A speech by Tony D’Aloisio, Chairman, Australian Securities and Investments Commission

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Introduction

Thank you very much for inviting me along today to speak to you about insider trading and market manipulation. I am delighted to be here—even on Friday the 13th!

My objective will be to provide the ASIC perspective in this area. ASIC is the regulator responsible for detecting, investigating and taking action; for example, for civil penalties and for delivering briefs to the Commonwealth Director of Public Prosecutions (CDPP) for criminal proceedings. ASIC can also seek enforceable undertakings and take administrative actions (e.g. bannings).

Until 1 August 2010, ASX had ‘front line’ responsibility for broker or market participant oversight and surveillance. That responsibility, from 1 August, passed to ASIC. One of the benefits should be to speed up the process between detection and, in cases which warrant it, investigation and enforcement. In saying that, it is important to note that ASX carried out the ‘front line’ surveillance work very well. The move to ASIC was driven more by removal of potential conflicts of interest between ASX’s role as a listed company and the supervision of the market on which it is listed, particularly if we move into competition for trading services.

In giving you ASIC’s perspective, I will be doing so largely at an ASIC policy level, focusing on the issues which we are dealing with and our approach and priorities.

I will not, for example, be focusing on specific legal interpretation issues within the relevant provisions themselves. I hope that will not disappoint an audience such as this which is steeped in analytical rigour (and rightly so) when it comes to the application of the law.

Also, in discussing ASIC policy, I will not move into broader policy issues which are matters for the Federal Government. This is because, as a regulator, our primary obligation is to work within existing laws and we use the established channels with Treasury to pass on input and views on possible changes to those laws. More importantly, however, we are in a federal election period and during this period the ‘caretaker conventions’ apply.

So let me turn to outlining ASIC’s perspectives in the area of insider trading and market manipulation.

The way I’ll do that is to make and expand on five points and then provide concluding remarks drawing those points together.
I am happy to then take questions and hopefully expand and clarify what I’ve said and answer questions on issues you wish to raise which I may not have covered.

My first point:

The underlying policy of the Corporations Act is (essentially) that markets should be organised in a way that encourages all investors to trust that they will be treated fairly. Any appearance that the markets allow insiders to trade using their inside information against investors at large will harm that trust and discourage participation in those markets.

Let me expand this point.

Much of the underlying philosophy of the Corporations Act is based on the group of theories generally referred to as the ‘efficient markets hypothesis’. Markets are left to operate with a minimum of regulation. However, two key regulatory underpinnings to the operation of the markets are disclosure (‘let the sunlight in’) and prohibition of certain practices, most notably the insider trading and market manipulation offences.

It is not difficult to see why these prohibitions are needed. When investors have confidence in the integrity of our markets, the economic benefits can be significant and are generally well recognised (e.g. lower cost of capital). Conversely, the economic damage caused by offences such as insider trading and market manipulation can also be significant (e.g. higher cost of capital).

While it is commonly accepted that these offences can result in a private loss for investors (and a private gain for the market abusers), market manipulation and insider trading also involve a less easily quantifiable, but nevertheless evident, public cost.

What do I mean by public cost? Well, the offenders are unfairly exploiting, for their financial benefit, the inherent information asymmetries between well-informed insiders and less-well-informed market participants, including retail investors. Both destroy trust in market fairness and efficiency, and represent a market failure if they are prevalent.

The public cost, which is the harm done to the integrity of the market and to confidence (i.e. perceptions of the integrity of the market), can lead to changes in broader market behaviour and pricing, and flow on into other adverse effects on the economy.

Conceptually, the public cost of insider trading and market manipulation can be expected to be seen in the first instance in a widening in the bid–ask spreads for all trading in the securities in question. This can spill over into
widening bid–ask spreads in the market for all securities, an increase in the cost of capital and a reduction in the market price of securities—not only for new and existing issues of the security in question but also for other securities. A reduction in market depth (reflecting reduced willingness to trade) and reduced trading volumes would also be expected.

In a dynamic analysis, these higher costs of capital and costs of trading would feed into lower returns on investment, less fixed capital spending and less potential and actual economic demand and activity over the economic cycle.

Unless they are caught and punished adequately, insider traders and market manipulators themselves do not incur much of these economy-wide costs. The conduct also creates a negative externality. Securities prices in the market are distorted, and consequently other buyers and sellers end up paying for inefficiencies in the market as a result of the offender’s conduct.

There are a number of academic studies which support the view that there are real economic costs associated with these offences. Similarly, that there are economic benefits to high levels of market integrity, brought about by strong enforcement against market misconduct in capital markets.

Though the debate about the pros and cons of insider trading and market manipulation has been quite contentious in some parts, it seems that from the point of view of actual practice, the debate has been settled. In a study of insider trading regulations in every country that had a stock market at the end of 1998, researchers in the United States found that 100% of the 23 developed countries, and about 80% of the 80 emerging markets, had insider trading laws on their books (i.e. prohibitions against insider trading).  

The same research paper looked at the extent of market integrity in all of those 103 stock markets and concluded that, on average, enforcing insider trading laws resulted in a real reduction in the cost of capital. Interestingly, though, the mere existence of insider trading laws was not itself associated with an improvement in market integrity, as measured by cost of equity capital. It was the enforcement of the laws that mattered.  

A 2007 paper by John Coffee generally supported this view and found that—particularly in the United States—a greater emphasis on enforcement helps reduce information asymmetries in a market and gives it a lower cost of equity capital.  

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2 ibid.  
My second point goes to the issue of how clean and fair our markets are.

Let me be clear: Australia’s markets are well regarded domestically and internationally. Indeed, the daily investment and spreads indicate that it is a market where domestic and international investors trade with confidence in the integrity of our markets.

Let me expand this point.

Australia’s markets are robust. The 2009 Johnson Report on Australia as a financial centre found that the Australian financial sector emerged from the global financial crisis strong, well regulated and highly regarded around the world. For the most part, it is competitive, efficient and innovative in meeting the needs of Australian households and businesses. It also found that Australia has arguably the most efficient and competitive ‘full service’ financial sector in the Asia-Pacific region.

The report noted that our financial sector ranked highly in international surveys on many of the key requirements for a successful financial centre. These include a highly skilled workforce and a first class regulatory framework that has served us well through the global financial crisis (GFC).

Through the GFC, Australia remained an attractive market to raise capital. Indeed, Australian equity issuance increased significantly, both in absolute terms and as a share of global issuance, during the course of 2008 and into 2009. In the nine months to September 2009, Australian equity issuance was the third largest in the world after the United States and United Kingdom. The ability to raise capital through the GFC, at least for the larger and more creditworthy companies, was arguably an important factor in limiting the economic downturn in Australia.

You simply cannot get these sorts of results unless investors have confidence in the integrity of the central piece of our financial markets—our exchange-traded markets.

So why is that? What can we draw from this? Clearly a number of things are working well:

- the robustness of our regulatory framework;
- for the most part, the corporate ethics of our boards and executives and other gatekeepers (e.g. market participants); and

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4 Australian Financial Centre Forum, Australia as a financial centre, Commonwealth of Australia, Canberra, 2009, (hereafter known as 'the Johnson Report'), covering letter by the Australian Financial Centre Forum to The Hon Chris Bowen MP, 17 November 2009.
6 ibid.
7 The Johnson Report, p.35.
• ASX’s and ASIC’s track record in detection, investigation and enforcement (included in this are the important roles of the CDPP and the courts).

These things have combined to ensure Australia has markets in which investors can trade with confidence (as they do each day).

**ASIC’s track record**

Let me expand on this last point and focus on ASIC’s track record in the area of insider trading and market manipulation.

Three years ago, as part of our strategic review, we reassessed our resources and approach to this area. The significant increase in retail investors in our markets and perceptions (at the time) of insider trading and market manipulation led us to increase our resources in this area. We did not engage in a debate on whether or not the perceptions of the prevalence of insider trading and market manipulation were correct. We thought it was better to increase resources with the objective of:

- increasing surveillance and detection;
- increasing the number of investigations; and
- focusing more on criminal penalties (because of their greater deterrence impact) than civil penalties.

How did we do that? What are the results?

In late 2007, we put in place, under the leadership of Commissioner Gibson (now Deputy Chairman):

- a dedicated markets area; and
- two dedicated market integrity enforcement teams (headed now by Chris Savundra and George Stogdale) with 40 full-time equivalent staff in each team working on market integrity cases.

In addition:

- ASIC and the CDPP enjoy a good working relationship, and we have continued to improve our approach of working towards a common purpose on these and other enforcement issues (always respecting the CDPP’s independence).
- ASIC has continued to devote resources to increase training and development of our staff, including additional skills for the legal and other professions.
- ASIC and ASX have worked more closely together at the detection and investigation level.
As we have now assumed the surveillance and supervision responsibilities of the markets from 1 August, we have also:

- established a Markets Disciplinary Panel to deal with breaches of the market integrity rules by operators and individuals—the panel consists of very experienced members with many years of industry knowledge; and
- established the Listed Markets Surveillance team to supervise real-time trading on Australia’s domestic licensed markets.

What is different to the period prior to late 2007 is more in emphasis: ASIC did investigate and prosecute these offences before then, but it did so within its general enforcement division. This structural change was important to give more direct focus to the area, as was increasing resources.

**ASIC’s enforcement record**

What are we achieving? We currently have 69 enforcement matters relating to market integrity and, since 1 January 2009, we have had 16 significant outcomes specifically relating to insider trading and market manipulation, including:

- four outcomes (three convictions and one guilty plea) for insider trading (Panchal, O’Reilly, Stephenson and Hartman);
- five outcomes (four convictions and one civil penalty) for market manipulation (Wade, Musumeci, Newing, Soust and Chan); and
- seven brokers have also been banned from providing financial services, for having engaged in either insider trading or market manipulation.

We have a further eight insider trading and market manipulation matters pending before the court on criminal charges.

This is a significant improvement on previous outcomes. In fact, we achieved the same total number of outcomes in the past 18 months as we did for the previous five or so years in total.8

These results are important in sending a clear message that ASIC has this area as a priority and it is resourced to detect, investigate and, with the CDPP, prosecute. The effectiveness of this approach is backed by the studies I mentioned earlier that say strong enforcement is needed if we are to maintain confidence in the integrity of the markets.

You can see from this that ASIC’s (and prior to August, ASX’s) track record has been important in maintaining confidence in the integrity of our markets.

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8 There were 16 insider trading and market manipulation outcomes between 1 January 2004 and 31 December 2008.
I am not suggesting that insider trading and market manipulation has been stamped out. There will always be room to do more.

In the end, however, the best guide remains the market itself. The trading on the market, and its attraction to international investors, gives us quite a degree of comfort that they have confidence in the integrity of our markets.

I should add that our commissioner oversight of the area will continue with Commissioner Shane Tregillis taking over from Commissioner Belinda Gibson, who is now focusing on her role as Deputy Chairman after having led this transition so successfully, as well as the integration of ASX surveillance into ASIC.

**My third point:**

ASIC regards these offences as serious and considers that (generally) they require criminal prosecution to maximise the deterrent effect.

Let me expand on this.

Currently, an individual who engages in insider trading in Australia and is found guilty of a criminal offence is subject to a maximum fine of $220,000 and/or five years imprisonment. For market manipulation, the punishment is a maximum fine of $22,000 and/or five years imprisonment.

A corporation found guilty of an offence for insider trading is liable for a fine of up to $1.1 million. For market manipulation, a maximum fine of $110,000 is applicable.

In the civil penalty regime, for both insider trading and market manipulation, an individual is liable for a fine of up to $200,000 and a corporation $1 million.

It is open to ASIC to pursue civil penalty proceedings instead of criminal proceedings for these offences. In making that assessment, ASIC weighs up a number of factors and works (under an Memorandum of Understanding (MOU)) with the CDPP.

Civil penalty proceedings have a number of advantages: they can be pursued by ASIC itself and not require another agency (CDPP), and they have (on the face of it at least) a lower standard of proof. In addition, civil penalty proceedings can provide quicker settled outcomes.

Nevertheless, ASIC’s approach in more recent times has been (generally) to pursue criminal proceedings for these offences. Although preparation for such cases takes longer (necessarily so with a high standard of proof and when individual freedom is at issue), ASIC’s view is that criminal
proceedings and sanctions, including imprisonment, are what will ‘focus the minds’ of those who may be inclined to stray (so-called ‘general deterrence’).

The Government recently reviewed the penalties for these offences. Before the dissolution of the Australian Parliament, the Corporations Amendment (No. 1) Bill 2010 proposed to increase some of the penalties on the insider trading and market manipulation offences. The Bill lapsed as a result of the dissolution and calling of the election.

For an individual, the proposed penalties for both insider trading and market manipulation were to be:

- the greater of $495,000, or three times the profit gained or loss avoided; and/or
- up to 10 years imprisonment.

For a corporation, the proposed penalties were to be the greater of:

- $4.95 million;
- three times the profit gained or loss avoided; or
- up to 10% of the body corporate’s annual turnover in the relevant period.

As outlined by the Government, the policy behind these changes was to:

- add to the deterrence impact; and
- bring the penalties more in line with those applying to cartel activity under the Trade Practices Act.

There are a number of similarities between insider trading and market manipulation offences and cartel activity. At the simplest level, they are each ‘white-collar’ crimes where the offender is often involved in the business that would benefit from the activity or transaction; they each involve exploiting information asymmetries between well-informed insiders and less-well-informed others; and both destroy trust in market fairness and efficiency.

As I said, the Bill has now lapsed. Importantly, if reintroduced and passed, it would set new levels and, as you know, courts will have regard to these new levels when applying the principles of sentencing.

Overseas markets also view these offences seriously. In the United States, an individual found guilty of insider trading can receive a fine of US$5 million or 20 years imprisonment or both. A corporation found guilty of the same offence faces a fine of up to US$25 million. While in the United Kingdom, a person found guilty of insider trading faces up to seven years imprisonment or an unlimited fine.
My fourth point:

When it comes to punishment, ASIC is focusing more on building the case to assist courts in sending (where appropriate) clear messages on general deterrence.

As you know, when sentencing an offender for these offences, the court takes into account a number of factors—including those outlined in s16A(2) of the Crimes Act 1914.

A recent review of insider trading cases (Juliette Overland) has shown that courts had most commonly taken into account 17 criteria:

1. amount of profit made
2. character of the offender
3. any expression of remorse or contrition
4. any extra-curial punishment
5. general deterrence
6. manner in which the information was acquired
7. personal circumstances of the offender
8. any breach of confidence
9. manner in which the trial was conducted and guilty plea
10. relationship with the relevant company
11. any delay in prosecution
12. prospects of rehabilitation
13. relationship with the securities industry
14. specific deterrence
15. acceptance of pecuniary penalty order
16. amount of money wagered
17. any hardship to the offender’s family.  

Punishment for insider trading and market manipulation offences has varied, affected principally, of course, by the circumstances of each case. In the recent past, individuals convicted of criminal offences received penalties

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ranging from a 12-month good behaviour bond with a conviction recorded\textsuperscript{10} to three years imprisonment.\textsuperscript{11}

In the past 18 months, seven individuals have been convicted of insider trading and market manipulation offences, and six of them were given a sentence of imprisonment. The average head sentence across these cases was 16 months imprisonment.

In some, but not all, of these cases, the court explicitly considered the impact of the relevant conduct on market confidence and integrity (the broader issues I discussed earlier) in determining penalties.

For example, in \textit{R v Hannes} [2002] NSWSC 1182, which remains one of Australia’s largest insider trading cases in terms of profits made, the court viewed the investors as victims of insider trading transactions. Moreover, the court stated that the defendant’s act had undermined the integrity of the securities market and noted that this would lead to a loss in market confidence and market efficiency.\textsuperscript{12}

This was reaffirmed in \textit{R v Rivkin} [2004] NSWCCA 7, where the court took into consideration the loss of market confidence as a determinant in assessing the quantum of penalty. The court also stated that it intended to use imprisonment as a method of sending out a deterrent message to the securities market and those who are engaged in the industry. The court emphasised the fact that detection in insider trading cases is so difficult that the only effective deterrent message that could be sent to the public is through penalties and sentencing.\textsuperscript{13}

In that case, Mr Rivkin was convicted of insider trading and sentenced to nine months imprisonment, to be served by way of periodic detention, and fined $30,000.

More recently, in this court, Justice T. Forrest has passed sentences in both an insider trading case and a market manipulation case—\textit{DPP v O’Reilly} [2010] VSC 138 and \textit{R v Chan} [2010] VSC 312 respectively. In \textit{O’Reilly}, his Honour stated (at [19]):

\begin{quote}
In insider trading cases I consider there are at least two victims; the seller or sellers of the stock at the lower price and the public, whose confidence in the integrity of the market must be diminished. The impact upon public confidence in the market is an important factor. The securities markets could not survive and flourish without the confidence of those who elect to invest in it.
\end{quote}

\footnote{10} in 2010, Mr Noel James Stephenson was convicted after pleading guilty to an insider trading charge brought by ASIC. Justice Fullerton convicted Mr Stephenson and released him without passing sentence by recognisance on the conditions that he be of good behaviour for 12 months and pay to the Commonwealth a pecuniary penalty in the sum of $20,000 by 31 July 2010.

\footnote{11} in 2007, Mr Dean Scook was convicted on 158 counts of market rigging and was sentenced to three years imprisonment, to be released after serving 14 months, upon giving a personal recognisance of $5,000 surety to be of good behaviour for the balance of the term.

\footnote{12} \textit{R v Hannes} [2002] NSWSC 1182 at para 90.

\footnote{13} \textit{R v Rivkin} [2004] NSWCCA 7 at paras 412 and 423.
My fifth and final point:

In the running of insider trading and market manipulation cases, assembling evidence to prove to the requisite criminal standard (because of the nature of the offences) continues to be a challenge for ASIC but one that it is continuing to meet.

Let me expand on the ongoing challenges for ASIC on satisfying the requisite standard of proof when bringing insider trading and market manipulation cases.

Insider trading and market manipulation offences are difficult to prove. This can be evidenced by the limited number of actions taken by regulators around the world. It is interesting to note that until 1990 only nine countries had brought any charges on breaches of insider trading laws. 14

Some of the challenges with evidence collection in insider trading and market manipulation cases include:

- detection of suspect trades can be difficult, particularly during heavy trading (by way of indication, in today’s electronic world a significant number of messages, such as offers, can be sent in one second);
- distinguishing manipulative from legitimate trading—particularly where there is a high volume of trading and algorithmic trading;
- there is often little in the way of a document trail when the offender engages in insider trading or market misconduct—proving possession of insider information can therefore be very difficult;
- obtaining witnesses to prove the communication of price-sensitive information between an insider and a trader in an insider trading case; and
- in some cases, the difficulty goes beyond possession of the inside information to proving whether the information a person possessed is ‘material’ as defined by the legislation.

In a recent paper on the continuing problems of proof in insider trading cases, one commentator (M. Duffy) summarised the challenges:

- Regulators will often find themselves in a position where they can identify a person with inside information on a particular security, a person who traded in that security, a relationship between the two persons and even evidence of communications between them (such as telephone records).

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• This may still not be enough unless there is some evidence of the content of the communications.

• Though a circumstantial case for communication may exist, it is usually necessary to establish what was said to identify it as price sensitive information.  

These evidentiary difficulties can become even more pronounced when the alleged offender, or some aspect of the conduct, is located in a foreign jurisdiction and evidence collection must be sought through available international mechanisms, such as the IOSCO Multilateral Memorandum of Understanding on Consultation and Cooperation and the Exchange of Information.

Now you may say (and quite rightly), ‘So what?’ ASIC is the regulator and it needs to meet the standard of proof. That’s fair enough. I am raising the issue, however, to assist in dealing with public or community expectations. Often the public’s (or media’s) information is a sharp movement in a share price and an event at about that time. A number of assumptions are then made and often a connection is made that the event caused the movement and that there must have been inside information. Those in the room know that a lot of proof is needed to make these links and to assemble the evidence. In a significant number of these situations, we know from experience, that the movements are explained by other factors or factors which did not involve inside information. The degree of difficulty and time that these cases take is not widely appreciated.

These expectations on swiftness and speed are no doubt reinforced by such films as Wall Street: the drama of a young man’s seduction by insider trading, together with the presence of the high-profile Gordon Gekko and, in the end, swift justice.

Reality is different. On any given day there will be a range of queries we will make (and before us, ASX made) of market participants. Some of these will lead to further review and some to investigation, and ultimately some might get to prosecution. The process does not have the glamour of Wall Street. It is, like other ‘police’ work, painstakingly detailed and with due and proper processes. That is what we believe the community expects. And being on ‘the beat’, so to speak, in this way is also important in disrupting potential misconduct.

Evidence and proof

Let me make some other comments on evidence and proof. Clearly, direct evidence (e.g. a phone call) can be very useful in these cases.

CAMAC published a report in June 2009 (known as the ‘Aspects of Market Integrity Report’). In it, CAMAC recommended that insider trading and market manipulation offences be included within the definition of ‘serious offence’ in the Telecommunications (Interception and Access) Act 1979, which would permit existing ‘interception agencies’ as defined in that Act, such as the Australian Federal Police (AFP), to apply for warrants to intercept telephone conversations for the purpose of investigating such offences.16

Following this, the Government included a reform to this effect in the Corporations Amendment (No. 1) Bill, which I have previously referred to, and it contained provisions in relation to interception. As previously mentioned, the Bill has now lapsed.

Other tools in relation to evidence

In recognition of the difficulties of evidence collection, suggestions have been made by commentators for other tools including:

- bounties and rewards—the US SEC has for some years been authorised to offer ‘bounties’ to people who provide information about insider trading in civil penalty cases. Indeed, it was recently reported that new whistleblowing incentives, proposed within the Dodd–Frank Financial Reform Act, mean that people who provide original information that leads to a successful SEC enforcement action would be entitled to 10–30% of any sanction collected over $1 million.17 Way back in 1989, in Australia, the Griffiths Committee considered and rejected the possibility of bounties on the basis that they were inconsistent with attitudes to the credibility of evidence and accepted principles and practice within Australian society.18

- leniency and immunity—the issue of whether an immunity policy should be put in place for persons reporting insider trading and market manipulation misconduct to ASIC has also been raised over the years. There is presently no formal immunity policy in place specifically for such reporting. There is, however, a protection for whistleblowers under the Corporations Act, and in criminal matters the CDPP has the power to indemnify witnesses in accordance with considerations that are outlined in the Prosecution Policy of the Commonwealth. Now

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contained as an Annexure to that policy is the specific policy formulated by the ACCC and the CDPP on *Immunity from Prosecution in Serious Cartel Offences*.

Each of these tools, and others that have been suggested, involves important issues that would require detailed consideration. These are policy matters and ASIC has not formed views.

**Conclusion**

Let me now conclude and draw these five points together.

There are a number of elements that, in my view, are necessary to ensure clean and fair markets, and which support confidence in the integrity of the markets (the policy embodied in the Corporations Act):

- the market must be reinforced by a solid legal and regulatory framework, understood and respected by all participants;
- the regulator must maintain a strong and continuous presence in the market; and
- punishment of offences, such as insider trading and market manipulation, must be clear and proportionate and deter others.

From the points I have made, we can say that:

- Australia does have a solid framework in this area;
- the regulator is focused on a strong and continuous presence;
- the CDPP and the courts are performing important roles in ensuring that precedents of clear and proportionate punishment are in place for these offences, and which recognise the importance of general deterrence.

The investment and daily trading on our markets does, I believe, support that we have market integrity. The additional resources ASIC has put into the area over the past three years and its track record have been important in underpinning that confidence, and these areas continue to be among ASIC’s top priorities. Overall, I believe that ASIC is meeting community expectations on what it should be doing with these offences.

Thank you.