2013

Blending fairness and efficiency: An analysis of its desirability in the context of insider trading laws in Australia

Afroza Begum
University of Wollongong, afroza@uow.edu.au

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Abstract

Purpose - The regulatory approach to insider trading (IT) in Australia is premised on a "blend" of fairness and efficiency which has generated an important controversy. The study aims to investigate this controversy by critically analysing the way the policy maker and judiciary have been striving to accomplish the regulatory goals based on this blend.

Design/methodology/ approach - This research is based on existing primary and secondary legal resources.

Findings - Regulation of insider trading (IT) with an appropriate enforcement mechanism has become an important issue in Australia. As part of this, a range of legal studies have unveiled significant difficulties in successfully prosecuting insiders which largely reflect a serious disappointment with the operation of the IT law. Whilst the output of this research motivates and enhances a broad scholarly debate on the credibility of the current regime in combating IT and in generating a strong form of deterrent against prospective insiders, there has been a dearth of intellectual inquiries (to the best of the author's knowledge) backed up by a reliable assessment about the merits of the law, and especially about the issue of how the courts are applying a "blend" of the two policy rationales: market fairness and market efficiency in resolving particular circumstances. It is submitted that this paper will contribute to filling this gap in the legal literature and the wider academic deliberation on the quality and effectiveness of the IT regime.

Originality/value - This paper is the original work of the author and has not been submitted elsewhere for publication.

Keywords

trading, blending, fairness, efficiency, analysis, its, laws, desirability, australia, context, insider

Disciplines

Arts and Humanities | Law

Publication Details

A. Begum, 'Blending fairness and efficiency: An analysis of its desirability in the context of insider trading laws in Australia' (2013) 20 (2) Journal of Financial Crime 203-221.

Blending Fairness and Efficiency: An Analysis of its Desirability in the Context of Insider Trading Laws in Australia

*Afroza Begum**

*LLB (Hons) and LLM (Rajshahi), LLM (Western Sydney), PhD (University of Wollongong, Australia), Professor of Law, Islamic University, Bangladesh (on leave); Honorary Fellow, Faculty of Law, University of Wollongong, Australia.

Abstract:

The Australian regulatory approach to insider trading (IT) is premised on a 'blend' of fairness and efficiency which has generated an important controversy. The study aims to investigate this controversy by critically analysing the way policy makers and the judiciary have striven to accomplish the regulatory goals based on this blend. Whilst the output of existing research stimulates scholarly debates on the credibility of the current regime in combating IT, there has been a dearth of intellectual inquiries into the application of this blend in resolving particular circumstances driven by contemporary needs and global imperatives. It is submitted that this paper will contribute to filling this gap in the literature and the wider academic deliberation on the quality and effectiveness of Australian IT law.

Key words: Insider Trading, Australia, Law, Market Fairness, Market Efficiency.

1. Introduction

Market fairness and market efficiency are primary policy rationales that fuelled the regulatory reforms in Australia to redress a number of fundamental flaws in the earlier provisions dealing with insider trading (IT) (Lyon & Plessis, 2005, pp. 8-10). The fairness approach (grounded on the equal access theory) advocates that IT provides an unfair advantage for the holder of information who can exploit its benefits, and correspondingly disadvantages/incapacitates the remaining market participants to obtain the same information by competitive means, which are morally and legally unacceptable (Carlton & Fischel, 1983, p. 858; Carney, 1987, pp. 868-876).[1]

In contrast, efficiency's traditional enquiry focus highlights IT's beneficial effects, suggesting that it encourages more effective, accurate and particularly timely price signalling for securities to the market. It has also been suggested that IT represents a legitimate reward for enterprise and as a form of 'compensation' for those decision takers in companies (See generally Anabtawi, 1989, pp. 385-399).[2] Arguably, the merger of these two rationales is very unlikely to produce the desired outcome of IT regulation, especially when they are conceptually designed and committed to pursue distinctive goals (*R v Firn* , 2001, NSWCCA 191; Mannolini, 1996, p. 151). Yet, empirical evidence is unavailable to suggest that endorsing either one or the other will advance the regulatory goal. Instead, academic research confidently demonstrate that efficiency cannot be generated in and of itself but rather is best achieved through the promotion of a transparent securities market that stimulates and sustains some core notions of fairness, such as the equality of access to information, the creation and maintenance of an informed market, and improved investor confidence (see generally North, 2009, pp. 249-253).

By adhering to the perceived spirit of the merged concepts as entrenched in the regulatory reforms in Australia, this paper argues that an appropriate interaction between 'fairness' and 'efficiency' is not only desirable but also inevitable to facilitate the goal of IT legislation, and that the regulatory objectives can be best ensured in an increasingly technologically advanced securities market through the combination of the core values of the two instead of trying to separate one from the other. In an attempt to substantiate this argument, the study develops a hypothetical scenario (where each — 'fairness' then 'efficiency' — is held up as a separate approach) based on available primary and secondary sources. It critically examines the appropriateness and effectiveness of the blend by placing a special focus on the way policy makers and the judiciary have striven to accomplish the two fundamental objectives — market fairness and market efficiency — in terms of both their extent and degree of

sophistication, despite the absence of a convincing past record of successful IT law enforcement in Australia (at least until very recently).[3]

Drawing upon the findings from an application of the above hypothesis, the paper concludes that fairness and efficiency are complementary in the Australian context where the blend has been endorsed on the basis of the need to promote investor confidence in the fairness and integrity of the market, rather than to espouse either of the two contrasting goals separately.

The following section begins with a brief exploration of the 'fairness' and 'efficiency' rationales in dealing with IT and highlights only a few contrasting aspects of these two approaches relevant to the main argument of the paper. Section 3 examines the background of IT regulation in Australia with special reference to the fundamental policy justifications that have been drawn from a merger of the two rationales. Section 4 analyses how the policy maker and courts have endeavoured to achieve the regulatory goals by striking a balance between the two rationales. Section 5 provides a conclusion.

2. Fairness and Efficiency as Competing Approaches

The long standing legal controversy over the feasibility and desirability of regulating IT remains unresolved in many jurisdictions, including United States (Beny, 2007, p. 238). The 'fairness approach' — supporting the need for regulation — claims that IT generates an unethical corporate culture by resisting a transparent and informed market, noting that such a corporate culture inevitably promotes unfair disadvantages of the ignorant market participants to evaluate all relevant information for investment decision-making (Carlton, 1983, p. 873).[4] This ultimately leads to illiquidity, disinvestment, and an erosion of investor confidence in the securities market. This fairness rationale aims to ensure that the market operates freely

and fairly with all participants having equal access and opportunity to relevant information (Griffith Report, 1989, 3.3.6; Rubenstein, 2002, p. 93).

In contrast, the 'market efficiency' approach, originally advanced by Professor Manne (1966) and opposing regulation ('Legalize Insider Trading'), maintains that IT is economically efficient because it ensures stock price accuracy and stock market liquidity by motivating managers to competently allocate information and maximise profits, for themselves and thus for others as the market rapidly moves in tandem with the results of their trades on best available (though initially inside) information (Carlton, 1983, p. 861). Supporting Manne's view, some authors affirm that trading on inside information effectively advances an efficient market that rewards individuals' creativity (Jacobs, 2005, p. 234). Australia, however, has adopted a somewhat different approach; its regulatory goals are reached through the combination of fairness and efficiency, which is considered in the following section. While a detailed analysis of Australian legislative responses to IT is beyond the scope of this article, a brief outline of IT provisions and elements is necessary to provide a theoretical framework for part 4 which will concentrate on the main argument of the paper.

3. Background of Insider Trading Regulation

The first Commonwealth legislative provision directly targeting IT was section 128 of the *Securities Industry Act 1980* (Cth), which prohibited a person who possessed material information of and had a connection with a body corporate from dealing in or tipping on its securities. As a series of deficiencies in this provision became evident from unsuccessful prosecutions, reforms were sought through, *inter alia*, the formation of different committees. The Griffiths Committee formed in 1989 was one such committee, a leading government law reform body created to examine the adequacy and effectiveness of IT regulation (Griffith's

Report, 1989, xi). An amendment subsequently made to the *Corporations Act 1989* by the *Corporations Legislation Amendment Act 1991* reflects its recommendations ('Insider Position and Consultation Paper' 2007). This Act, with its fundamental policy objectives of market fairness and market efficiency, signifies an important departure from the earlier legislation in terms of the scope and prosecution process of IT (Explanatory Memorandum, 1991).[5] With some minor modifications in 1998, those IT provisions were incorporated in Part 7.11 Div 2 and 2A in the *Corporations Act 2001* and later replaced by the current provisions integrated in Part 7.10 Div 3 of the *Corporations Act 2001* as amended by the *Financial Services Reform Act 2001* (FSR).

The inherent difficulties of the original provisions and 'the overkill by the FSR' have necessitated further reforms of IT provisions by other committees: the Companies and Securities Advisory Committee (CASAC) and then by the Corporations and Market Advisory Committee (CAMAC) (Harris, 2009, p. xix). Some of the concerns that CAMAC has been dealing with include whether confidential briefings by corporations to their analysts would amount to 'not generally available' information and whether this could lead to the erosion of public confidence in the fairness and integrity of the Australian market.

3.1. Policy Justifications for Regulating IT in Australia

Originally, there were four underlying policy rationales that prompted the emergence of IT laws in Australia. First, the fiduciary rationale formed the basis of regulating IT. It recognised a relationship of trust between the insider and the relevant corporation as imposing an obligation on the insider not to misuse its information by virtue of that relationship (Jacobs, 2005; Mannolini, 1996). This theory lost its significance with the incorporation of the 'information - connection' approach to the current provision which does not require any nexus between insider and the corporation to constitute IT; it vividly extends 'possession of

inside information' to any person, including those other than fiduciaries or with link to fiduciaries or corporations (Pompilio, 2007, p. 468). A second rationale concerned the misappropriation theory, which considered inside information analogous to a property of a corporation and therefore its use for personal benefits inappropriate (Jacobs, 2005). This theory also fails to motivate the reach of s 1043A of the Act, since a person can come to possess information that is price-sensitive and not generally available without having misappropriated it (Pompilio, 2007). In other words, misappropriation is not a necessary requirement; possession of price sensitive information is enough to attract the current provision.

The third rationale focuses on market fairness, which upholds the position that every participant in the securities market should be afforded equal opportunity to evaluate information in order to make trade decisions (Griffith's Report, 1989; Rubenstein, 2002). Finally, the fourth rationale, that of market efficiency, reflects a belief that IT has damaging impacts on the fiduciary functions and the overall liquidity of the market, as well as on investor confidence in investing and in the integrity of the securities market (Rubenstein, 2002, 93).

Under the current Australian regime, however, 'fairness' and 'efficiency' have become jointly the core tenet for regulating IT. These two rationales that the Griffiths Committee and the present regime have categorically underlined are reinforced by both CAMAC and CASAC (CAMAC's IT Report, 2003).[6] CASAC maintains that market fairness and market efficiency are the most appropriate rationales for prohibiting IT rather than what it sees the more limited fiduciary duty or misappropriation rationales (Insider Trading Consultation Paper, 2007). Yet, the way in which the two rationales are formulated raises doubt as to 'whether they are elements resolving into a unified theory' or whether they are 'two distinct rationales' having separate and/or contrasting goals. Some academics see a sharp contrast

between the two and some are inclined to accept them as complementary —which will be examined in detail in part 4.

3.2. Insider Trading Prohibition and Its Elements

The *Corporations Act 2001* (Cth) (the Act) prohibits conduct by persons in possession of inside information, and then defines an 'insider' as a person having possession of price sensitive information of a relevant corporation that is not generally available but, if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products (ss 1043A & 1042A). Accordingly, at least four fundamental elements need to be satisfied to constitute IT. These are:

- Possession of inside information
- The non-public feature of information (not generally available)
- Materiality of the information
- Knowledge of the person

3.2.1. Possession of Inside Information

Possession of inside information constitutes the first element of IT, precluding earlier requirements of 'connection' or association with the corporation or its other privileged sources and the actual use of information. The non-public feature and materiality of information are of paramount importance in ascertaining whether material constitutes 'inside information' under section 1042A of the Act. This section defines information as:

> (a) matters of supposition and other matters that are insufficiently definite to warrant being made known to the public; and
> (b) matters relating to the intentions, or likely intentions, of a person.[7]

Unlike the former provision and the position in other countries, it does not endorse any requirement of 'specificity' or the manner in which the information appear. Accordingly, judicial interpretations and the way the court imposes liabilities on the person holding information are far reaching. In determining an IT claim, the court in *Doff*, for example, disregards the 'form' of information, suggesting that it is the substance — especially the quality of the information having capacity to motivate the securities price — that should be of primary significance (*R v Doff,* 2005, NSWSC 50. 27; Overland, 2006, p. 213). *Citigroup* transcends the narrow meaning of information to include 'factual knowledge obtained by means of a hint or veiled suggestion from which the receiver of it can impute other knowledge' (*ASIC v Citigroup,* 2007, FCA 963.534; *Hooker v Baring,* 1986, 10 ACLR 462.463). Similarly, the cumulative effect of four separate pieces of information (*Hannes,* 2000, NSWCCA 503. 28), as well as the source of information and state of affairs communicated (*R v Rivkin,* 2004, NSWCCA7.132) were considered 'information' for the purpose of IT law. Young J adds further that 'information' goes beyond 'knowledge' and may include a 'rumour' that something has happened with respect to a company which a person neither believes nor disbelieves (Hooker 468; *Rivkin* 2004. 127). Based on this broad formulation, Rubenstein (2002, p. 95) argued that it seems possible now to embrace '[profit] and loss forecast, the existence of merger discussions, the discovery of a new vaccine and perhaps even silence in the face of a direct question or statement' as encompassed in the realm of information as implanted in the IT law.

3.2.2. The Non-public Feature of Information

The non-availability of information in the public domain must have to be proved to succeed an IT claim under section 1042C of the Act which explains that information is deemed 'generally available' if:

(a) it consists of readily observable matter; or

(b) both of the following subparagraphs apply:

(i) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information; and

(ii) since it was made known, a reasonable period for it to be disseminated among such persons has elapsed [published information]; or

(c) it consists of deductions, conclusions or inferences made or drawn from either [a readily observable matter or from published information].

This section, however, does not provide any clear insight into issues such as 'readily observable matter', 'person who commonly invest', and 'reasonable period' (Mannolini, 1996, pp. 151, 156), which have eventually promoted 'differing and inconsistent judicial interpretation' (Rubenstein, 2002, p. 93). Also, there is no indication of how, to whom and for how long information must be disseminated prior to trading (Kendall and Walker, 2006, pp. 345-49).

3.2.3. Materiality of the Information

Materiality of information is the third element of IT which has to be proved: that is, whether 'if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of the securities' (s 1042A of the Act). The likelihood of the particular event occurring following the release of information and its impact on the company's performance are dominant factors in assessing materiality (North, 2009, p. 242). In other words, the price sensitivity of information that motivates the decision-making of an investor largely determines the extent of materiality under section 1042A of the Act. Hence, materiality appears to lose its significance in an IT trial when information fails to impact on the price of the securities. Such a link, however, is very difficult to establish in circumstances where the price has been affected by other prevailing pro-factors in the market (Lyon, 2005, p.27). Nevertheless, judicial decisions confirmed that a 'significant level of probability'

(*Hannes,* 2000), a 'good chance'(*Rivkin,* 2004) or a 'substantial likelihood'(*Citigroup,* 2007) of a takeover of a target corporation can influence its share price and can extinguish the materiality of information in contention.

Yet, complications have been engendered surrounding the issue of whether section 1042A requires not only the information be important enough to affect the relevant security price but also its impact be reasonably measured to establish an IT claim.[8] Very often, these requirements as to materiality generate difficulties for the prosecution to satisfy and frustrate a positive outcome (Tomasic, 1991a).

3.2.4. Knowledge of the Person

The knowledge of the person who possesses the information is the fourth element of IT. Section 1043A of the Act provides two ways the knowledge element can be satisfied. First, it should be within the knowledge of the defendant that the relevant information is not generally available and, if it were generally available, might have a material effect on the price or value of the securities. Second, the defendant ought reasonably to have known that the information was non-public and price sensitive (Rubenstein, 2002, p. 96). Knowledge as to the truth of the information itself or its potential price sensitivity is not required to establish an IT claim, otherwise rumours and gossip would almost never amount to information (Overland, 2006, p. 715). Judicial decisions, however, unveiled notable difficulties in proving that mental element, especially the fact that the 'defendant was motivated to trade as a direct result of having that particular information' (Tomasic 1991a, pp. 115–16). Also, this is very hard to prove, and often hinders successful prosecution of IT (Tomasic 1991a, pp. 115–16).

The following section examines the ways in which policy makers and the judiciary have attempted to achieve the regulatory goals by striking a balance between market fairness and market efficiency.

4. Legislative and Judicial Approaches to Dealing with Fairness and Efficiency

As mentioned, the policy objectives under the current regime have been drawn from a blend of fairness and efficiency which has caused significant controversy. Academic and judicial evaluations are split on the suitability of this blend. Some consider this desirable in the Australian context; others argue that these two rationales are inherently incompatible and must be traded off to some extent (see e.g., Lyon, 2005, p. 9; Jacobs, 2005, p. 235; Seeman, Freeman & Adams, 1999, p. 221; Mannolini, 1996, p. 151). The latter go further, arguing that the merger of these two ostensibly distinct policy goals produced a 'legislative astigmatism' that failed to adequately appreciate their unique conceptual bases before endorsing it as a benchmark for prohibiting IT and continues to hamper clarity of statutory definition that is required for implementation, including judicial decision making (*Firn,* 2001. 53).[9]

However, from the policy makers' point of view, this 'union' (rather than a policy embodying the pursuit of the two separate goals) is firmly designed to restore investor confidence in the market that had plummeted in the wake of the October Market Crash of 1987 and redress the overall public dissatisfaction with the operation of IT regulation and its low level of prosecution (Griffith's Report, 1989, 3.3.6; Tomasic, 1991, pp. 121-122). The government's policy view is revealed in the *Explanatory Memorandum to Corporations Legislation Amendment Bill 1991* (hereinafter Explanatory Memorandum) which confirms that IT law aims to 'protect investors and make it attractive for them to provide funds to the issuers of securities for the greater and more efficient development of Australia'. The Griffiths Committee indicates that the optimal use of 'efficiency' is best ensured when investors are confident of the fairness and integrity of the market. In particular, the CAMAC discussion paper employs the term 'economic efficiency' not simply in terms of reflecting informational efficiency but rather to a definite perception that IT might have adverse impact on investor

confidence leading to destabilising investment and the overall fundraising function of the market (Companies and Securities Advisory Committee, 2001).

Through this undertaking, the policy maker projects one fundamental vision, namely that, 'IT damages an essential component in the proper functioning of the securities market, that is investor confidence', which can only be regained through the promotion of a free and fair market where no one has unerodable informational advantages over others (Griffith's Report, 1989, 3.3.4 & 3.3.6). Yet, the 'fair' approach as construed under this policy is broad in scope and its literal application arguably restricts genuine analysis and research in the securities market (Rubenstein 2002, p. 93). The Australian Institute of Company Directors (2002), for example, questioned how it's fair in a supposedly free market society to make people liable for merely by their possession of the 'non-public' information which has lawfully been acquired through their own innovative efforts and expertise unaided by any 'connection' to the relevant company.

Nevertheless, some incentives for the legitimate analysis can be traced out in IT provisions purporting to acknowledge individuals' skills and diligence in conducting independent research of generally available information.[10] To that end, both the Griffiths Committee and the Parliament's commitments concur in recognising that there is a need 'not to penalise individual initiative and diligence' and that 'for some type of information, cleverness, swiftness and efficiency are to be encouraged' (Griffith's Report, 1989, 4.5.8.; *Firn,* 2001, 57). The Explanatory Memorandum stressed that it was not the intention of the Griffiths Committee to regard inside information as such things as deductions and conclusions which investors or other market participants may make by using their intelligence and genuine endeavour.

Consequently, an insertion of limbs 2 and 3 to section 1042C of the Act aims to facilitate 'efficiency' in the Australian market by providing defence for trades based on independent research of generally available information. Gething, (1998) however, argued that the diligence research lawfully drawn from an area which is not public may still create liability. He provided (p. 613) an example:

> Assume A discovers by lawful means the existence of a mineral deposit under land owned by B ltd., a listed company. Specifically, A analysed the publicly available reports on the land and then flew over the land in an aeroplane fitted to detect magnetic anomalies. A buys shares in B Ltd without disclosing the information**.**

Such an example, as he contended, is less likely to offer a defence under section 1042C (c) of the Act which requires some objective assessments by the court of the way information reached the defendant. Also, substantial confusion prevails over the definition and use of the terms of 'deductions, conclusions or inferences'. Nonetheless, it is a timely and implicit recognition by the law that all information does not need to be 'socialised' and that 'there is a need to encourage generation of some of the benefits associated with market efficiency theory' (Jacobs 2005, p. 236).

Despite legislative efforts to create an equilibrium between costs and benefits of the fair and efficient market, the unique feature of Australian IT legislation has raised some practical problems for the courts in interpreting various elements of IT on the basis of this 'merged' concept. Setting a normative standard for such an interpretation also seems problematic, especially when the legislative base is not clearly articulated (Jacobs, 2005). *Kruse* (unreported 1999) and *Firns* (2001), for example, with their identical scenarios highlight the problem of how the use of the same merged concept could produce conflicting results. In both cases, one of the legal issues was whether information that was readily observable overseas would be regarded as 'generally available' under the Australian IT law. The trial court in *Firns* maintained that the term 'generally available' did not include information

which was readily observable in a foreign jurisdiction (Papua New Guinea) and the defendant was convicted of IT (2001. 3), whilst in *Kruse* the trial judge upheld the opposite view(unreported 1999). Even though the conviction in *Firns* was overturned on appeal, and there has been a strong consensus among judges that readily observable information overseas would be adequate to render that information 'generally available' in Australia, some legal issues remain unresolved. These include whether the knowledge of a research report that carries 'strong hint' of the prospects of a particular corporation would be considered 'generally available' information (Bollen, 2003, pp. 441-442). Mason P (*Firns*, 45) maintained that the Parliament left the courts with in a difficult situation, with '[an] interpretative scheme embodying the ambiguous embrace of the market fairness/equal access and market efficiency theories' and further commented (*Firns*, 53) 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'.

Yet, there has been no convincing evidence to suggest that IT goal is best achieved through endorsing only one or the other approach (see, e.g., Carlton, 1983). This article develops a hypothetical scenario where the law aims to address IT problems from contrasting viewpoints, either by upholding a 'fairness' or an 'efficiency' rationale.

In the first scenario, the IT regime seeks to achieve the goal by generating a level playing field where all market participants have equal access and opportunity to evaluate generally available information to make investment decisions, and by enforcing liabilities for the possession of 'non-generally available' information of corporation concerned. Its strict adherence, however, would undeservedly diminish the incentive to make competent use and dissemination of information in an increasingly interconnected technologically advanced world driven further by the 'globalisation' imperatives, and penalise individuals' inventive

initiative, knowledge and expertise (Bollen, 2003, p. 438; Seeman, 1999, p. 232). As Pompilio (2007, p. 469) argued:

> [F]airness can only ever provide a shaky foundation for s 1043A. Even if consensus could be reached on what is “fair” in the context of IT and such considerations ought to play a role in guiding policy, a law based on such a foundation will likely depart from the economically efficient arrangement and it will be useful to understand and measure the costs associated with that departure.

Back in the 1980s, a leading US case of *Dirks v Securities Exchange Commission* (1983, 463 US 646) demonstrated important shortcomings of the market fairness theory. Ray Dirks, the insider who was a stock analyst, uncovered a significant level of fraud of a US insurance company and subsequently advised his clients to sell the stock. The company eventually collapsed when the information came into the public knowledge. Dirks was convicted of securities fraud but succeeded on appeal to the US Supreme Court. Perhaps it was highly unlikely that he could have avoided the allegation had the market fairness theory been entrenched in the US. He could not have avoided the allegation either under Australian law as his knowledge and possession of inside information placed him at an informational advantage over remaining market participants (Jacobs, 2005, p. 247), even though his acts should deserve commendation rather than condemnation (Mannolini, 1996, p. 155).

Upholding the observations in the *Dirks’* case, Lyon and du Plessis maintained that the equal access theory is problematic in practice because it overlooks the cost effective exercise of potential information in the marketplace and cannot guarantee actual information symmetry for all investors. The authors also observed that principles of fairness must be compromised in some instances to attain efficiency (Lyon and du Plessis; North, 2009, p. 247). In particular, when private knowledge about pending bids, capital raisings or earnings announcements inspire the trading, any potential short term efficiency gains are significant and should not simply be compensated by recourse to the theoretical and elusive route of

accomplishing 'investor confidence' in the market (Cox, 1986, pp 642-655). The results of doing so often magnify the damage to allocational efficiency in the capital market as the fairness approach has 'indiscriminate application to insiders, "outsiders" and diligent market analyst alike' (Mannolini, 1996, p. 154).

Again, a piece of information may not be material in itself but its blending with other additional information may produce 'materiality' and then it has the genuine risk of unjustifiably attracting criminal sanctions. This is unjustified because of the way the mere knowledge and possession of inside information invite criminal liability and because the term 'information' has been very broadly interpreted by the courts (as noted earlier, see also Golding and Kalfus, 2004, 392). More fundamentally, this type of assessment of 'materiality' — in the absence of a meaningful safeguard against such a 'fairness-only' centred approach — will inappropriately obstruct the growth of optimally accurate market intelligence within the Australian market and impede its rational development in a dynamic securities world. Furthermore it would hamper the intellectual growth within those persons employed in or comprising entities involved in the Australian market. The concern that persons may be unjustly penalised for their own intellectual endeavours has been underscored in several judicial decisions, even when such an exception is already in place under the existing IT law. In *Futuris*, for example, the court expressed concern by observing that while IT provisions are:

> designed to allow fair play in the marketplace, …. one must not be too free in his construction because otherwise people who have taken proper advice and have intended to act legally may, through some technicality, find themselves in prison. (as put by North, 2009, p. 245).

To address and redress such concerns, Australian IT law incorporates the 'readily observable' exclusion, wherein information published and standards of analysis provide a defence for trading on the basis of research, examination and analysis of matters in the public arena.

Granting these exemptions paves the way for recognising and addressing the dynamics of the progressive environment in which stock trading takes place and is reflective of globalised imperatives (Jacobs, 2005, p. 241). In particular, this recognition enables corporations to keep pace with the reality of the modern securities market, and motivates entrepreneurial skill and innovation. With these exemptions in place, whilst the current regime facilitates trades by the utilisation of analysis,[11] it also preserves the underlying spirit of combating IT through the introduction of the concept of the 'Chinese wall'[12] (or information barrier) which is to be maintained between an entity's research and trading activities (Bollen, 2003, pp. 441-442). Academic research, however, reveals that the overly generous concessions provided by these exemptions trigger IT by a determined insider trader, (Tomasic, 1991b, p. 142) and that the application of the 'Chinese wall' is far from infallible, its imperviousness essentially depending on the 'the discretion and meticulousness of the parties involved'(*Chinese wall).* Bollen (2003, pp. 441-442) further argued that the process of analysis may itself provide 'some temptation' for analysts to pursue personal gain by trading those securities before publishing their research findings, rather than advancing efficient growth to the market. Again the ethics of the individuals involved remain crucial. Nevertheless, research analysis as developed in the Australian market is considered by at least some to be 'more effective than comparable overseas regimes', and is seen as genuinely committed to attempting to accommodate contemporary corporate concerns by setting standards for 'efficiency' which have received authoritative recognition by the courts (see e.g., Bollen 2003, pp 439 & 430). [13]

The Court in *Firns* (2001), for example, while stressing the need to sustain information parity, did not resile from quashing on appeal a conviction in a case of what some may perhaps have been considered an inventive exercise of the use of 'inside information', involving a foreign court decision, the knowledge of which had been transferred to particular persons in Australia and resulted in significant share trades.[14] Mason P (*Firns*, 2001. 3)

emphasised the concept of 'observability', that is, that the decision was able to be easily observed, though no one may have chosen to do so (other than the parties involved). Whilst the conviction was 'set aside based upon misdirection' of the jury due to the inclusion of the words 'by those in Australia' (*Firns*, 2001. 93) in relation to the 'ready perceptibility' of the information, the Court made some pertinent observations(*Firns*, 2001. 5, 79, 83).

In resolving an issue as to whether a decision of the Supreme Court of Papua New Guinea was deemed in Australian law as 'readily observable in Australia' when it was acted upon, Mason J observed that the term 'readily observable' is not defined in Australian Corporations Law, and s 1002B(a) is inserted to ensure that 'the efficient, the speedy or the diligent' are not penalised 'at least to the degree encompassed by the opaque "*readily observable matter*",' (*Firns*, 2001. 68) nor does the legislation define 'the class of persons by whom the material is to be "readily observable"', but which cannot be confined to existing shareholders or even those … on the ASX (the latter, he notes, not being 'confined to Australians', *Firns*, 2001. 70).

As North has observed, the modernisation of communications generally as well as of securities trading has drastically changed the traditional perception and 'a broad interpretation of the term "generally available" was required to promote economic efficiency' (North, 244).[15] Technological advancement and the requirements of globalisation obliged his Honour to interpret the term in a broader sense. However, it should be noted that Mason (*Firns*, 2001. 62) observed that:

> A legislative commitment to an efficient as well as a fair market does not translate automatically into deciding that the "efficient" single trader is to be encouraged at all costs. But it does reinforce my decision to interpret par (a) literally, without forcing its language into a predetermined purposive mould.

His Honour categorically relied on the ‘capacity of information’ to being perceived instead of confining ‘observability’ to that which is able to be perceived by the direct ‘unaided’ use of the human senses. He reinforced the distinction by pointing out that the readiness of perceptibility needs to be judged having regard to the modern means of telecommunication, including internet, telephone, fax and so on which enable persons to ‘observe information immediately if indirectly’ (*Firns*, 2001.78), rather than to the viewpoint of individuals located in Australia merely using their natural senses (Zhen, 2002, pp. 19-20). ‘Observability’ was not to be taken as necessarily to ‘be located *a priori* in the Australian capital cities where the ASX has a physical presence’ (*Firns,* 2001. 88), with Mason referring more than once to the impact of modern means of communication on ‘observability’ (*Firns,* 2001. 81-82, 84).[16] His Honour (*Firns,* 2001.77) also maintained that it does not matter how many people actually observe the relevant information … and when it was in fact observed. Information may be readily observable even if no one observed it’.

In this regard, Jacobs recommended that the court’s view expressed in *Firns* provides a very persuasive direction towards an understanding of the elemental forces of a globalised climate in which stocks are traded and provides a positive framework that will be more useful in the future (Jacobs, 2005, p. 239).

In *ASIC v Citigroup Global Markets Australia*, the legal issues were whether Citigroup traded on ‘readily observable matter’ and whether the alleged instruction to discontinue buying shares in the Patrick Corporation constituted information under the IT provision. Jacobson J maintained (*Citigroup*, 2007. 546-547, emphasis added):

> [The] question of whether a matter is “readily observable” is one of fact. Observability does not depend on proof that persons actually perceived the information; the test is objective and hypothetical….Where the information is a “matter of supposition”, the question of whether it is generally available depends on whether the supposition is *capable* of being made or drawn by other investors based on readily observable matter ….

His Honour then (558-571) substantiated this by arguing that the 'readily observable matter' was the existence of a substantial likelihood of a takeover of Patrick, as evidenced by bid rumours and increased trading volumes in its shares, that the non-public feature of the information was therefore extinguished by the time the instruction concerned was carried out. Consistent with this, the Court in *Gambotto* held that the price-sensitive material information alone is very unlikely to motivate an investment decision unless it's influenced further by other factors, such as the nature, future prospective and the asset of the corporation, market value, dividends and so on (*Gambotto v WCP Ltd* (1995) 182 CLR 432. 447). Essentially, all of the above display the courts' 'adoption of a literal approach' to decision taking which reflects an increasing recognition of the 'efficiency paradigm as the most appropriate underpinning' of the IT regime in Australia in regard to contemporary corporate needs and values (Jacobs 2005, p. 236). Such recourse, where appropriate, to a literal meaning (particularly where legislation is silent in matters of definition), neither artificially 'forcing' meaning nor ignoring informational context, can be seen to have served commerce well.

Thus, at this point it is realistic to observe that the 'fairness' approach lacks logical and adequate support to be the *exclusive* force behind IT regulation and that the legislative justification for incorporating those exclusions to promote efficiency gained a solid foundation in various judicial decisions, among them those cursorily discussed above.

In the second scenario, market efficiency is the single-minded goal of IT. In the context of securities market, economic efficiency typically refers to informational efficiency, meaning the existing share price will fully reflect all relevant available information of the corporation concerned, and thus a market where investors lack the ability to out-profit or predict in return (Goshen & Parchomovsky, 2001, p. 1229). According to this rationale, IT provides effective price signalling for the stock to the market by facilitating earlier incorporation of the relevant

information and by inhibiting variations in investors' access to the corporate information (Ayress & Choi, 2002, p. 320). This standpoint, however, underpins an unfair privilege for a few sophisticated investors and their advantaged associates by leaving at stake the legitimate interests of the less informed, ultimately causing a deterioration in the integrity of the market (Beny, 2007, pp. 243-244). Also, the way efficiency is reached through IT invites unethical elements into the corporate culture, such as the concealment of important information and delays in public announcements (Khan, 1992, pp. 1003-04). As it is observed (Explanatory Memorandum, 1991, (307):

> …even if insider trading enhances market efficiency by faster dissemination of information, the negative effects of insider trading on investor confidence outweigh these efficiency benefits.

Again, apart from a very long-established argument against IT that 'insider trading is an inefficient compensation device' that works very imperfectly (see generally Carlton, 1983, pp. 876-879), the mode of dissemination of information through IT and the resulting scope (for its application) have raised serious doubt about its even minimal impact (negative or positive) on efficiency. To quote from Pompilio (2007, p. 469):

> …informational efficiency is not an end in itself for securities regulation. Rather, it is important only to the extent that it leads to improved risk-sharing or real economy outcomes… In driving securities prices to informationally efficient levels, informed trading is of no consequence to the aggregate amount of wealth in society because it is fixed by assumption. The usual arguments regarding the benefits of informed trading in facilitating efficient resource allocation outcomes is not compelling in such cases.

Extending this argument one step further, Kahan (1992, p. 1004) asserts that IT provides inaccurate ways of utilising information, leaving only a 'noisy' indicator of calculating significance of and prospects for company value. This noisy and uncertain signal is more likely to escalate speculative trading activities, leading to confusion about the accuracy of share price and magnifying price volatility, which in turn make the market more unreliable and unproductive instead of efficient (North, 2009, p. 249).

Australia responded to this dilemma by enacting laws to regulate IT. The policy maker, however, while rejecting the effective price signalling formula, preferred to retain market efficiency as one of the principal rationales for promoting investor confidence in the fairness of the market. The underlying policy justifications (Corporations Committee, Inside Trading Discussion Paper, 2001) emphasised:

> …all trading activities with insider information that is not generally available are not essentially damaging towards investor confidence. Instead, "the market expects and benefits from such trading, which fulfils one of the primary functions of any market — namely market discovery — and contributes to overall market efficiency"

Pursuant thereto, the judiciary has developed progressive approaches to dealing with various elements of IT to sustain efficiency gains, as pointed out. The decisions in *Firns*, *Hannes* and *Citigroup* demonstrate the courts' strong consensus about the need for greater efficiency.[17] There is also a growing realisation among academics that in recognition of efficiency gains a reward for individuals' intelligence and diligence in a globalised corporate climate is indispensible. However, time and again, it is concluded that such a reward must not be made at the expense of market fairness and overall stability. Thus where in many instances efficiency consideration became inept in advancing the desired goal of IT regulation, the court has invoked the fairness approach to remedy the situation. In the *Rivkin*, *Doff* and *Petsas*' cases, for example, the courts emphasised the spirit of 'fairness' to protect the integrity of the market and penalised those who contravened the law. The court in *Rivkin* (2003, 44 (2)) observed:

> [IT] has the capacity to undermine to a serious degree the integrity of the market in public securities. It has the additional capacity to diminish public confidence not only so far as investors are concerned but the general public as well.

The courts on numerous occasions underlined the seriousness of IT, noting its deleterious effects on the market (particularly in terms of threatening market integrity by undermining investor confidence, through market distortions, increased market volatility, and profit-taking

created by informational inequities); and highlighted the need for its penalty/deterrence aspects to properly fit the degree of criminality involved, and thus provide a powerful message to dissuade others from committing the same offence (See, e.g., *R v Frawley,* 2005. NSWSC 585, 27 & 40; *Australian and Securities Investments Commission v Petsas,* 2005, FCA 88. 17-18; *R v Hall,* 2005, NSWSC 890. 114-124; *Doff* case, 2005. 53 ; *Rivkin* case, 2003. 423; *Firns* case, 2001. 62 & 65).

Overall, the findings of the court demonstrate that the current 'merged' (or perhaps 'two currents in a single stream') regime, despite its limitations, is capable of producing effective deterrence to IT and motivating a corporate culture where fairness and integrity of the market can be ensured.[18]

Based on the above, it would be also difficult to posit that economic efficiency should be the *sole* basis for regulating IT in Australia, as the legislative reliance on the fairness approach as manifested in the inclusion of relevant qualifying clauses proved to be appropriate when facing the increasing need to ensure the integrity of the market, and for judiciary to apply dynamic approaches to cases that had been thrown up by activities detected within the market and so to secure 'efficiency' whilst maintaining the desired 'fairness'.

Also, all the above suggests that neither of these two rationales ('efficiency' or 'fairness') is unique, self-sufficient and without limits. The need to sustain efficiency while supporting the competent use of inside information by a few individuals with sophisticated knowledge and skill may unfairly sacrifice the fundamental principle of IT law by failing to recognise and redress the losses of other market participants that emerge from their incapacity to access to the relevant information. On the other hand, neither is it the fair application the 'fairness' principle to make people liable merely for their possession of inside information, especially

when this may be gained by reason of their intelligence or diligence or even of a lawful privilege in a progressive securities market (Brudney, 1979-1980, p. 346).

To address the compelling factors advanced by both sides as to the legitimacy of their rationale, a balancing approach is therefore inevitable, one which will recognise the legitimate needs of all relevant stakeholders not by measuring or valuing one role over another or separating one from the other but by reassessing and uniting the core notions of both rationales. In so doing, it must be observed that the issue is not the justification of IT regulation based on the 'merger' but rather its cautious application with regard to others' interest, with regard to who can lawfully forward 'efficiency' in an interdependent world while preserving integrity in the market. As Jacobs (2005, p. 238) suggested:

> Dispensing with the distinction yet retaining equity can be achieved by acknowledging two mutually supporting realities: that the increasing speed and diversity of information networks in the modern world has imbued the market efficiency rationale with a conceptual integrity which hitherto it has not had.

Similarly, North (2009, p. 253) recommended that the application of some key concepts of market fairness such as equality of access, investor confidence and transparency in corporate disclosure could best facilitate 'economic efficiency' in the securities market. This finds a dominant expression in a statement of the UK Draft Code of Conduct (Insider Trading Discussion Paper 2001):

> In all markets, a balance has to be struck between often conflicting factors: the desire to bring all information to bear upon the price, through trading and disclosures: the need to reward properly those who research or analyse: and the damage that can be done to efficient pricing if people fear those with whom they are trading have some informational advantage over them.[19]

In Australia, the policy maker and the judiciary have endeavoured to accomplish this task by integrating and applying fairness and its certain exemption clauses to advance the central goal of investor confidence in the integrity of the market as well as keep IT instruments abreast of the changing environment.

5. Conclusion

The foregoing demonstrates that the IT regime in Australia has been premised on a blend of market fairness and market efficiency which has engendered significant controversy. This risks undermining the authority of the regime. The article has examined a small part of this controversy that has appeared in the literature, which provides no statistical confirmation to suggest that the IT regulatory goal could have been best achieved had either of the two approaches been endorsed in Australia. Instead, it demonstrates that each suffers from a series of fundamental flaws and the issue of which is the fundamental approach to be preferred in dealing with IT remains deeply debated. This is an issue not only at a theoretical level but the legislator and the judiciary have to address both market and relevant technological development in the real world. A rigid application of one or the other will inevitably depart from the regulatory goals of IT laws in Australia and instigate further debate. Given the distinct conceptual background of the two approaches, whilst it is logical to acknowledge that the blend's application at some points may generate practical problems, it is still desirable in the Australian context to stimulate 'efficiency' in the market while at the same time preserving market fairness and integrity for the investing public. Even though measuring the implications of the blend is the subject of innovative scholarly inquiry, and further empirical and conclusive research is needed to reach a more balanced conclusion, it is submitted that the argument developed in this article may contribute at least in part to diminish the on-going debate on the 'merged' concept utilised in the Australian jurisdiction.

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[1] The latter's access to the relevant material may be delayed, though the trades of the 'insiders' will alert others to the possible existence of market relevant information. They must obtain the same information by legal means, or may be forced to adopt similarly morally and legally dubious strategies, such as the receipt of information that is in essence stolen or illegally obtained ('leakages' or 'leaks'), to uncover relevant material to similarly enhance their decision making. IT ultimately undermines investor confidence necessary for the proper functioning of the securities market- see Carlton & Fischel, 1983, p. 858; Carney, 1987, pp. 868-876.

[2] See generally, Anabtawi I, 1989, pp. 385–99; House of Representatives Standing Committee on Legal and Constitutional Affairs. *Fair Shares for All Insider Trading in Australia: Report* (hereinafter

Griffiths Report) [3.3.4]; 'Legalize Insider Trading' [an interview with Professor Henry Manne by Larry Elder] Professor *Capitalism Magazine* 24 September 2004 http://capitalismmagazine.com/2004/09/legalize-insider-trading/. For a full exposition of his views on pro- IT, see Manne 1966, where he argues for a very laissez faire approach to IT as a free market good rather than evil as it promoted ever greater 'efficiency' by signalling rapidly to the market the true status of a company. See also, Anabtawi I, (2003–2004) pp. 835, 837 where the author discusses stock options for senior executives etc and price movements that follow their award as evidence of their being a form of IT.

[3] There have been a total of 20 cases in the past three years compared to 15 criminal cases in the 11 years to 2008, 5 of which were unsuccessful: Williams R, 'Change in tactics helps ASIC net more offenders' Business Day, *Sydney Morning Herald* 14 February 2012. See text, http://www.smh.com.au/business/change-in-tactics-helps-asic-net-more-offenders-20120213-1t21r.html#ixzz1uTq00jE7. For more details, see part 4.

[4] Carlton and Fischel, for example, recommended, '[prohibiting] insider trading may be an overly blunt weapon to combat the problems of moral hazard and unbundling': see Carlton and Fischel, 873.

[5] Parliament of the Commonwealth of Australia, House of Representatives, *Corporations Legislation Amendment Bill, Explanatory Memorandum*, 27207/91 Cat. No. 91 3660 X, 1991.

[6] CAMAC's IT report states that, '[the] generally stated rationale for the prohibition of insider trading relates to market fairness and market efficiency': Corporations and Markets Advisory Committee (2003). *Insider Trading: Report*, (ii).

[7] Under section 1042 A of the 2001 Act, '*"inside information"* means information in relation to which the following paragraphs are satisfied: (a) the information is not generally available; (b) if the information were generally available, a reasonable person would expect it to have a material effect on the price or value of particular Division 3 financial products.'

[8] The Act sets reasonable person standard to measure the effect of information on the price or value of the securities: see section 1042A of the Act; North, 2009, p. 242.

[9] Mannolini,1996 151; the court in *Firns* observed that '[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….' See *Firns* [53] (Mason J) & [55].

[10] The Explanatory Memorandum explains that the test comprised in this section was introduced because '…information directly observable in the public arena would not be regarded as generally available, as it has not been 'made known'. It was considered that a person could be liable for insider trading where he/she traded in securities on the basis of, for example, an observation that the body corporate had excess stocks in a yard. This was not the intention of the provision.' See Explanatory Memorandum [326].

[11] North observed that 'the readily observable matter exclusion seeks to ensure that trading is permitted based on information or facts "directly observable in the public arena" even when the information does not fall within the published information test.' See North, 2009, p. 237.

[12] 'Chinese wall' typically denotes '[the] ethical barrier between different divisions of a financial (or other) institution to avoid conflict of interest. A Chinese wall is said to exist, for example, between the corporate-advisory area and the brokering department of a financial services firm to separate those giving corporate advice on takeovers from those advising clients about buying shares. The "wall" is thrown up to prevent leaks of corporate inside information, which could influence the advice given to clients making investments, and allow staff to take advantage of facts that are not yet known to the general public.' See *Chinese Wall*. Available at URL: http://www.investopedia.com/terms/c/chinesewall.asp.

[13] Bollen recommends that Australia '... is in some ways a number of years ahead of comparable overseas regimes in its application to research analysts.' See Bollen, pp. 439, 430.

[14] Mason P, Hidden J agreeing (Carruthers AJ, dissenting).

[15] North, 2009, p. 244; *Firns* [78], [81]. The court also held that '[the] market fairness/ "equal access" paradigm cannot be invoked as the *sole* basis for interpreting the criminal offence': *Firns* [2].

[16] *Firns* [81]–[82], [84]. Mason P pointed out that the 'point of present relevance is that the objective and hypothetical circumstances are to be looked at, not merely the actualities in the particular case' [88].
[17] Jacobs maintained that the adoption of a literal approach to judicial decision making 'reflects the increasing credence given to the efficiency paradigm as the most appropriate underpinning of the insider trading regime'. See Jacobs, 2005, p. 236.
[18] The Australian IT regime has been criticised for a series of reasons such as its complex nature, difficulties in proving its elements and associated evidentiary difficulties with the criminal trial proceedings. Yet, as Overland observed that there has been success in recent years in criminal trial and conviction for IT which can be 'viewed as a welcome development to the laws on IT'. See Overland 2006b, 708; Overland 2006a, pp. 219–21. It has also been observed that the European and Australian approaches are now more closely aligned.
[19] As referred to in '*Insider Trading Discussion Paper*', 4.

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