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Corporations and Financial Services Division  
The Treasury  
Langton Crescent  
PARKES ACT 2600

By email: [reviewofsanctions@treasury.gov.au](mailto:reviewofsanctions@treasury.gov.au)

Dear Sirs,

## Review of Sanctions for Breaches of Corporate Law

The Securities & Derivatives Industry Association welcomes the Federal Government's review of the penalties applying to breaches of the *Corporations Act 2001* and the *Australian Securities and Investments Commission Act 2001*.

We would like to comment on sanctions in two particular areas of concern to our Members:

- Market Manipulation and the removal of the intention element (Part A), and
- Advisory Services and the size and proportionality of penalties (Part B).

### Part A. Market Manipulation

*(These matters were first raised in our submission to Treasury of 3 February 2003, and later in our letter of 27 April 2006.)*

#### Summary

Our submissions, set out more fully in the following discussion, are summarised as follows:

- The provisions are not identical to the pre-FSR provisions, despite there being no apparent intention to change them.
- There is considerable uncertainty about the impact criminally and particularly civilly of the new provisions.
- There is uncertainty of what conduct is now criminal manipulation and about the potential risks of a criminal breach.
- The uncertain impact of the *Criminal Code* is our main concern. The separation of the criminal elements of the market offences into the *Code* has led the law into uncharted waters. The novelty and complexity of the approach required by the *Code* makes it difficult to be confident about how the sections will operate.
- The civil consequences of the post-FSR provisions have serious implications for *legitimate* transactions, for example those that are large and/or involve no change in beneficial ownership that are executed in accordance with the dealing rules applying to our Members.

## Discussion

Amendments to the market manipulation provisions of the *Corporations Act* (principally s1041B) took effect in 2004. In short, from 2004 the 'intention defence' (the old s998(6)) was removed from the Act, and transferred to the *Criminal Code*. This was in line with Government policy for all Commonwealth Acts which include criminal offence provisions to be covered by the Code.

The implications are:

- for **Criminal** prosecutions – uncertainty as to the application of the *Criminal Code* to market manipulation provisions (and no cases since 2004 have clarified the situation)
- for **Civil** penalty actions (by ASIC) & civil actions (between private litigants) generally – the removal of the intention defence means that an otherwise legitimate transaction may constitute a breach of the Act.

## Old and new provisions

The *Financial Services Reform Act* (FSRA) adopted new market manipulation provisions in Part 7.10, Sections 1041A-1041E, replace provisions previously found in Sections 997 and 998 in relation to securities and Sections 1259 and 1260 with respect to futures. The new provisions, of course, no longer apply only to securities and futures, but rather to financial products able to be traded on the financial market.

The principal provisions of concern to the SDIA are those now in Section 1041A-1041C. While they do not have exact equivalents in the earlier provisions, following are the principal pre-FSRA corresponding provisions.

- s1041A – old s997, 1259 (market manipulation)
- s1041B(1) – old s998(1), 1260 (false trading & market rigging – creating a false or misleading appearance of active trading, etc)
- s1041B(2) – old s998(5) (transactions involving no change in beneficial ownership)
- s1041C – old s998(3), 1260(2) (false trading & market rigging – artificially maintaining etc. the price of financial products)

The new provisions have caused the SDIA significant concern, insofar as there is considerable uncertainty about the impact criminally and particularly civilly of the new provisions.

## Defining culpable manipulation

The SDIA is particularly concerned about the uncertainty of what conduct is now criminal manipulation and about the potential risks of a criminal breach. This is particularly the case where it is proposed to engage in transactions which it may be argued are likely to create a certain effect, although those responsible for the transaction do not have a purpose or intent to manipulate the market in the wrongful sense explained by Mason J in *North v Marra Developments*, quoted below.

The difficulty of distinguishing between transactions which are commercially proper but have or are likely to have an impact on price or the level of trading or market activity, on the one hand, and those which should be regarded as unlawful manipulation, was pointed out in the important reasoning of Mr Justice Mason in *North v Marra Developments Ltd* (1981) 148 CLR 42.

At that time, referring to the provision, the equivalent of which is now s1041B(2), although in slightly different terms (the word "likely" was substituted for "calculated" some time ago), Mr Justice Mason said that the policy of the statutory prohibition was to protect the market for securities against activities which result in artificial or managed manipulation. It:

*“seeks to ensure that the market reflects the forces of genuine supply and demand. By ‘genuine supply and demand’ I exclude buyers and sellers whose transactions are undertaken for the sole or primary purpose of setting or maintaining market price.*

...

*Transactions which are real and genuine, but only in the sense that they are intended to operate according to their terms, like fictitious or colourable transactions, are capable of creating quite a false or misleading impression as to the market or the price. This is because they would not have been entered into but for the object on the part of the buyer or of the seller of setting and maintaining the price, yet in the absence of revelation of their true character, they are seen as transactions reflecting genuine supply and demand and having, as such, an impact on the market. ...”*

In other words, intent to have an effect on the market or price in order to mislead (or under the earlier equivalent of s1041A, to induce others to engage in transactions) is the element which distinguishes culpable manipulation from activities which should not be so regarded.

### **The uncertain impact of the Criminal Code**

A principal concern of the SDIA is that the new provisions remove some of the important statements of intention which were previously in s997 and the defences which specifically refer to purpose in s998(6) and 998(8). No explanatory memorandum, report or discussion paper has considered these changes in depth, nor has there been an opportunity for submissions and weighing of alternatives<sup>1</sup>.

The application of the Criminal Code to particular provisions is uncharted territory. There is no case law on its operation. The novelty and complexity of the approach required by the Code makes it difficult to be confident about how the sections will operate.

While the defences in subsection (6) and (8) of the old s998 have not been reproduced in s1041B, a prosecution for breach of s1041B would still have to establish an unlawful fault required by the Code, but again, it is not clear precisely what fault element or elements will be required and whether they will be less likely to depend simply on an unlawful purpose.

Section 5.6 of the *Criminal Code* specifies the mental element needed for a defendant to be guilty of creating a result (in this case, creating a false or misleading appearance):

- he or she intends the result;
- he or she is aware the result will exist in the ordinary course of events; or
- he or she is aware of a substantial risk that the result will occur and, having regard to the circumstances he or she knows, it is unjustifiable to take the risk

(i.e. intention, knowledge or recklessness).

Subsection 1041B(2) says a defendant is deemed to have created a false or misleading appearance where he or she enters into matched orders or a trade with no change of beneficial ownership (or “**NCBO** trade”).

While we have discussed the issue with ASIC, we are not in a position to state their view. However, we note the comment in your email of 17 March:

*“The optimistic view, which ASIC takes, is that under s.1041B(2), a defendant would only be criminally liable if he or she:*

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<sup>1</sup> The Explanatory Memorandum to the Financial Services Reform Bill stated:

*The market misconduct provisions in proposed Part 7.10 are based on the current provisions in Parts 7.11 and 8.7 of the Corporations Law. These have generally been retained in their current form but their scope has been extended, as appropriate, to apply to all financial products and markets. (EM at paragraph 15.1)*

The Explanatory Memorandum left most participants and commentators with the impression that apart from the new civil penalty provisions and the adoption of the *Criminal Code* there was to be no substantive change to the market misconduct provisions under the *Corporations Act*.

- *intends a false or misleading appearance;*
- *is aware that such an appearance will exist in the ordinary course of events; or*
- *is aware of a substantial risk that the act will create a misleading appearance and, having regard to the circumstances he or she knows, it is unjustifiable to take the risk.”*

It is probably a fair summary of our view to say, as you did in the email of 17 March:

*“The pessimistic view, which SDIA takes, is that it is enough to establish criminal liability if the defendant intended or was aware or reckless that matched trades or a trade without change of beneficial ownership would occur.”*

As we said in the cover letter to our submission of 4 February 2003

*“The uncertain impact of the Criminal Code is our main concern. The separation of the criminal elements of the market offences into the Code has led the law into unchartered waters. The novelty and complexity of the approach required by the Code makes it difficult to be confident about how the sections will operate.”*

Our earlier comment still applies. No case law or other regulatory developments since 2003 have assisted to clarify the situation. Our earlier advice suggested that the uncertainty in the criminal context may make it harder for the authorities to prosecute parties for market manipulation, so there are difficulties for all concerned.

In the SDIA’s submission, it is quite unfortunate that the required element of fault in a criminal case under the sections has been made so uncertain by the failure to repeat the specific intent provisions in the former sections. Even in a criminal case, both sections 1041A and 1041B have drafting which is susceptible to a construction that the physical element for the purposes of the Criminal Code can be established by demonstrating that a transaction, objectively speaking, was likely to have a certain effect, whatever the intention of the party engaging in it.

When combined with the statements of the “fault” element in section 5 of the Criminal Code, the construction is open that a transaction is unlawful if it can be said to be likely to have a certain effect for the purposes of either section 1041A or 1041B and there has been conduct which is reckless in relation to that, or where the mere conduct as such can be said to have been intended as distinct from being accidental and without any intention to bring about an improper consequence. This creates significant uncertainty and concern for the parties proposing to engage in transactions, the motivation for which is not improper.

In the SDIA’s submission, the drafting, even for criminal purposes of those sections, and of section 1041A, 1041B and 1041C, should be revisited with a view to making much clearer the distinction between lawful and unlawful trading activity, having regard to the dividing line drawn by His Honour Mr Justice Mason.

#### **Civil consequences – sections 1041A and 1041B(1)**

The potential civil consequences of the provisions cause our Members even greater concern.

At least in some respects, the previous comparable sections contained statements of specific intent or purpose which either a plaintiff must establish, or which provided the defendant with a defence. Those provisions are no longer included. For criminal law purposes, reliance is then placed on the provisions of the Criminal Code.

That does not apply in civil proceedings for the recovery of damages or the imposition of a pecuniary penalty, with the result that no civil standard of fault is stated. What would be required to prove to establish civil liability is unclear, but a plaintiff or ASIC, in seeking a civil penalty, would turn on a proper construction of the provisions of the section, unaffected by the Criminal Code.

There was already some uncertainty arising out of statements of Sackville J in *ASIC v Nomura* (1998) 160 ALR 246; 29 ACSR 473. In the course of his judgment, Sackville J referred to the use of the term “likely” which now appears in both section 1041A and 1041B. He had regard to the fact that the provisions then created a criminal offence, and was then able to say, obiter, that:

*“Yet, if ‘likely’ means a ‘real chance’, a trader who neither creates nor intends to create a misleading appearance, commits a criminal offence of his or her conduct merely creates a real chance of a misleading appearance. In my opinion, the language of the subsection creates an ambiguity which should be resolved in favour of an alleged contravention. The narrower construction of ‘likely’ does no violence to the object of the legislation as expounded in North v Marra.”*

Even Mr Justice Sackville’s “narrower construction” only appears to require that the person transacting intends his or her act and that it was not necessary to prove that the offender knew a false or misleading effect was likely to be created. Now that we must turn to the Criminal Code to find the relevant fault, but that is not relevant to a civil breach, Mr Justice Sackville’s reasoning by reference to what was involved in a criminal breach may be inapplicable in a civil action. It does seem clear, in any event, from his judgment that it a civil plaintiff would not be required to establish that the defendant at the time of the allegedly contravening conduct, knew that a false and misleading appearance was likely to be created by the conduct.

Hence, in order to limit the civil consequences of what is in effect a serious allegation, even civilly, of market manipulation, it would be necessary to rely, in the case of the application of section 1041A, on such terms as “artificial” in relation to price.

In relation to s1041A, precisely what is an “artificial” price is not defined. Large transactions often move the market and, in a sense, create an artificial price. Insofar as both ASIC and the ASX have accepted the lawfulness of certain stabilisation activities in recent years, is it possible at all to take the view that those activities cannot be attacked as setting an “artificial” price? Will they be open to attack by third parties, or those seeking to resist enforcement of their bargains? Will this provision have implications for our stockbroker members executing large “special crossings” in accordance with ASX Market Rules which permit large trades over \$1m in value to be transacted and then reported to the market without the need to meet the previously existing market in the relevant securities?

Where section 1041B(1) is concerned, the concept of a false or misleading effect in a civil case is potentially as broad as in any misleading or deceptive conduct action. It is not evidence that the plaintiff would have to prove any intent or other fault.

There have been civil cases in which parties to a commercial transaction have litigated the question whether the transaction was unenforceable because of alleged insider trading or manipulation. The SDIA is concerned that the uncertainty about the operation of the provisions, and particularly sections 1041A and 1041B(1) pose a continuing and uncertain threat that what are negotiated commercial transactions and not an attempt to have an improper impact on the market may be upset or attacked by a party which decides it is against its interest to fulfil the bargain.

Where civil penalties are concerned, while the conduct must be seen by a court as “serious” before it is appropriate to impose a civil penalty in respect of the conduct, the principal elements which would need to be established in an action for a civil penalty potentially are the same as for any other civil action and the civil burden of proof and rules of evidence apply.

## Section 1041B(2) – Civil Consequences

In relation to the application of section 1041B(2), there is another specific concern. That section proscribes, both criminally and civilly, transactions that do not involve any change in the beneficial ownership of the product. Section 1041B(3) provides that:

*“An acquisition or disposal of financial products does not involve a change in beneficial ownership if:*

- *a person who had an interest in the financial products before the acquisition or disposal; or*
  - *an associate of such a person;*
- has an interest in the financial products after the acquisition or disposal.”*

What if it is desired to move the “beneficial ownership” of financial products around within a corporate group, moving them from one entity to one of its associates? This may be a commercial justifiable reorganisation of the holding in ownership of assets. As it stands, at least civilly, it appears to be potentially an illegal act. That particular problem is causing significant concern.

Moreover, our Members do not have the option of facilitating such transactions off-market transfers, since this would breach ASX Market Rule:

- Rule 16.2.1 requires that all “Cash Market Transactions must be made in a Trading Platform”, or otherwise
- Rule 16.12.1 which requires the reporting of crossings..

The civil consequences of the post-FSR provisions have serious implications for *legitimate* transactions by our Members. In a civil suit, or civil penalty action by ASIC, this is especially the case once the ‘overlay’ of the mental elements discussed above is removed. For example, the following scenarios may trigger prima facie breaches of s1041B(2):

- A. Crossings (i.e. where a stockbroking firm acts for both the Buyer and Seller) by a Responsible Entity (or other Fund Manager) where it is decided to ‘switch’ stocks from one fund to another under the Fund Manager’s control (e.g. MLC <Fund A> to MLC <Fund B>).
- B. Proprietary Trading (i.e. where a firm trades in shares on its own account with the intention of making a profit or hedging an exposure to the market). In terms of s1041B(2)(c), this may involve acquiring financial products with the intention of disposing of “...*the same number, or substantially the same number, of those financial products at a price that is substantially the same as the [price they paid to acquire them].*” The same would apply to a sale followed by buying-back. In large volume transactions, a small price difference can give rise to substantial profits, which may mean that the price of the sale (or buy-back) could be said to be “*substantially the same*”. This appears to be an unintended consequence, but clarity is required as to whether these unintentional NCBO proprietary transactions are regarded as contrary to s1041B(2)(c).
- C. Crossings from an individual to his/her self managed superannuation fund. (Accountants quite often recommend that when a client nears retirement age they should make an undeducted contribution to the super fund and with the current changes to superannuation, particularly in the lead-up to 30 June 2007, many of these transactions are taking place.)
- D. Crossings from an individual to their spouse (e.g. David Smith to Janet Smith).
- E. Crossings from an individual to their company account or family trust.

- F. Crossings from a family trust to a superfund (e.g. David Smith <Family Account> to David Smith<Superannuation Fund Account>).
- G. Selling and buying back on the same account (either in the name of an individual or a company) to crystallise a loss. (This is common in the lead-up to 30 June.)
- H. Crossings from one brother to another brother to split up the assets of a self managed super fund
- I. Crossing from a company account to another company account (e.g. ABC Pty Ltd to XYZ Pty Ltd) to tidy up affairs and to have holdings all in the one name - it is assumed that the shareholders and directors of the company of ABC and XYZ are the same
- J. Crossings from a parent to their children as a gift (e.g. parents have in the past bought shares for their children and had to do so in their own name because the child is a minor. Once the child turns 18, quite often the parents ask that our Member firms cross those shares to an account set up in the adult child's name.)

### **ASX Developments**

*AOP Crossings:* Developments in market trading platforms are increasing the likelihood that transactions involving no change in beneficial ownership (“NCBO”) under s1041B(2)(a), and transactions that are matched orders or “regulated offers” under s1041B(2)(b), may arise. ASX has changed its rules to facilitate Automated Order Processing (“AOP”), especially in the area of Direct Market Access (“DMA”). This involves client or principal orders, especially from sophisticated institutional clients, being passed directly to the market (i.e. “Straight Through Process”), without any human intervention by the market participant (i.e. our member firms). This practice is encouraged by ASX because it adds depth and liquidity to the markets, and ASX is on the record as saying it wants to increase the level of DMA trading in line with overseas trends. However, it also increases the chances that NCBO transactions arise, either deliberately, e.g. where a fund manager wishes to switch securities from one fund to another (i.e. with both those funds having the same underlying beneficial holders), which it is obliged to do through the market for audit or governance reasons, or accidentally, e.g. where a fund manager’s buy order is ‘hit’ by another of its own sell orders, by operation of the automated ASX trading system, resulting in an NCBO trade.

For some time the ASX rules have facilitated the increased use of AOP, for example by providing an exemption from the crossing and principal trading requirements, provided a prior disclosure was made to clients. In November 2005, ASX requested comment on proposals to further facilitate DMA trading. ASX is proposing a number of changes to trading rules in order to facilitate and attract more liquidity through DMA trading. The proposals affect the following areas:

- o Crossings (i.e. where the market participant acts for the buyer and the seller): removing the need to appear at the priority price for 10 seconds & allowing crossings within the spread. (This long standing rule is designed to flag the intention to cross to the market to allow other firms to participate); and
- o Certification: liberalising AOP system certification requirements.

*Superannuation fund Crossings:* In May 2007, ASX issued a circular to market participants regarding crossings involving the movement of stock into a person’s superannuation fund<sup>2</sup>. In this Circular, ASX indicated that in the lead-up to 30 June 2007, movements of shares from a person’s account to their superannuation fund<sup>3</sup> would not trigger action by ASX under Rules 16.2.1 or 16.12.1.

<sup>2</sup> *Movement of Securities into Superannuation Funds by Transactions involving No Change in Beneficial Ownership* ASX Circular No.253/07 23 May 2007

<sup>3</sup> for example, via transactions analogous to Scenario C. discussed above

It is anomalous that, while ASX regulatory policy (consistent with Government superannuation policy) is to *facilitate* the movement of securities into superannuation funds, the *Corporations Act* would criminalise such conduct, or at least make it a breach of the *Act* liable to bring with it civil sanctions.

### **Proposal**

Accordingly, our Members would support moves to amend the statute:

- to clarify that ASIC's 'optimistic' interpretation discussed above will apply, namely:
  - Under s.1041B(2), a defendant will only be criminally liable if he or she:*
    - *intends to create a false or misleading appearance of active trading or market or price in financial products on a financial market;*
    - *is aware that such an appearance will be created in the ordinary course of events; or*
    - *is aware of a substantial risk that the act will create a misleading appearance and, having regard to the circumstances he or she knows, it is unjustifiable to take the risk, and*
- to state that there will be civil liability only where a defendant had prior knowledge, intent or recklessness as to a false or misleading appearance.

Ideally, for clarity this would be achieved by amendments to the *Corporations Act*, not the *Criminal Code*. In so doing, such an amendment would restore the defence previously provided by **s998(6)** of the *Corporations Law*, which stated:

*“...it is a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading or market or price in financial products on a financial market.”*

As a resolution to the issue, perhaps the former wording could be used, with the addition of a reference to recklessness, for example:

*“...it is a defence if it is proved that the purpose or purposes for which the person did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading or market or price in financial products on a financial market, provided that the person was not reckless as to whether or not such a false or misleading appearance would result.”*

### **Part B. Proportionality & Size of Advisory Services Penalties (Part 7.7)**

In terms of sanctions, FSR made some key changes to the area of advisory services requirements in Part 7.7 of the *Corporations Act*.

The two main statutory obligations which apply to the giving of personal advice to retail clients are:

- a. the obligation to have a reasonable basis for advice (aka. the 'know your client know your product' rule); and
- b. the obligation to disclose interests and benefits which may influence the advice.

Pre- and post-FSR, the failure to disclose interests was a criminal offence. However, the obligation to have a reasonable basis for advice was not. The latter has only been a criminal offence since FSR became effective in March 2004. Moreover, as the following table shows, its penalty is much higher than that for the disclosure of interests offence.

**Reasonable basis for advice** (Ref: Pre-FSR s.851; Post-FSR s.945A)

Pre-FSR Penalty	Post-FSR Penalty <sup>4</sup>
(Not an offence)	\$22,000 fine (i.e. 220 penalty units), 5 years gaol, or both

**Disclosure of Interests** (Ref: Pre-FSR s.849; Post-FSR s.947B(2) etc)

Pre-FSR Penalty	Post-FSR Penalty
\$550 (i.e. 5 penalty units)	\$550

This raises questions as to appropriateness of criminalizing the offence of failure to give reasonable advice, and the proportionality of penalties in the area. Is a failure to have a reasonable basis for advice necessarily worse than a failure to disclose interests? The latter has at its heart the prevention of fraud, and the fiduciary obligation to advise clients if the adviser's personal interests - e.g. preferential commission arrangements for the recommended products, or substantial personal holdings in the subject security – could reasonably be expected to influence the advice given to the client. As such the failure to disclose interests is potentially more serious than the failure to give reasonable advice.

The recent history of the enforcement of the know your client/know your product rule by ASIC gives weight to the argument that it is difficult to justify its criminalisation in 2004, let alone according it the same penalty as the very serious offence of **market manipulation** under s1041A & s1041B of the Act. To our knowledge, ASIC has only prosecuted one person on charges related to the know your client/know your product rule, in 2005<sup>5</sup>. The more appropriate approach is remedial action to protect investors and/or civil action to recover loss, rather than criminal prosecution. Indeed, this was the alternative taken by ASIC in a major regulatory action in 2006, when a large number of breaches of the know your client/know your product and other rules were detected<sup>6</sup>.

<sup>4</sup> This penalty also applies to a number of other associated obligations, like the obligation to give a Statement of Advice under s.946A

<sup>5</sup> *Tasmanian financial adviser sentenced on charges of failing to provide a statement of advice* ASIC Media Release 05-370 (where the adviser received a good behaviour bond)

<sup>6</sup> *ASIC accepts legally enforceable undertaking from AMP Financial Planning* ASIC Media Release 06-251

While it may be overly hopeful to expect that the know your client/know your product rule be decriminalised as it was before FSR, we submit that a review of penalties in Part 7.7 be undertaken, to ensure consistency and proportionality.

We are grateful for the opportunity to provide input in the review of sanctions in corporate law. Thank-you for the opportunity to provide these comments. Should you require further information, please contact Doug Clark, Policy Executive on 0417 168804 or [dclark@sdia.org.au](mailto:dclark@sdia.org.au).

Yours Sincerely,



**David Horsfield**  
**Managing Director**

*ABOUT SDIA:* The Securities & Derivatives Industry Association is the peak body representing the interests of market participants in Australia. SDIA was formed in 1999 at the time of the demutualisation of the Australian Stock Exchange. Currently we have 66 member organisations which account for over \$5bn worth of trading daily on the ASX which is approximately 98% of the market. In addition we have over 1300 individual members and are working to build the profession of stockbroking. Our member firms employ in excess of 8,000 people.