COMPANY LAW
ADVISORY COMMITTEE

FOURTH INTERIM REPORT

to the

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STANDING COMMITTEE
OF ATTORNEYS-GENERAL

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SECTION A - INTRODUCTION

1. In the light of current discussion of questions of misuse of confidential information, and what is referred to as "insider trading", the Company Law Advisory Committee has decided to present this report on the problems raised by the proposal contained in section 13(b) of the General Revision Bill (draft of 21st May 1969). Consideration of this draft has involved consideration of the existing provision contained in section 124 and in sections 126 and 127, and proposals for amendment of sections 126 and 127 as contained in the General Revision Bill.

2. The Committee does not consider that directors and other officers of companies should not hold shares in the company. Even if it did, it would be impossible in existing circumstances to give effect to any such view. Nor does it consider that any restrictions should be placed on the mere acquisition or disposal of shares or other interests on the part of directors or other officers. It recognizes, however, that where such persons make improper use of confidential information, the law should provide a penalty at least commensurate with the extent of the wrong committed. Its consideration of the proposed amendments, therefore, proceeds upon the basis that the acquisition or disposal is not wrong in itself, but that the circumstances may make it so.

SECTION B - MISUSE OF CONFIDENTIAL INFORMATION

3. Section 124 of the Act provided (by sub-section (2)) that an officer of the company shall not make use of any information acquired by virtue of his position as an officer to gain directly or indirectly an improper advantage for himself or to cause detriment to the company. It also provides (by sub-section (3)) that an officer who commits a breach of the section shall (in addition to liability to a penalty of $1,000) be liable to the company for any profit made by him or for any damage suffered by the company as a result of the breach.

4. I t is proposed by section 13 (b) of the General Revision Bill (draft of 21.5.1969) to add a new section 124A. Sub-section (1) of this section will impose liability on an officer who "makes use for his own benefit or behalf of any special confidential information which he acquired in his capacity as an officer and which, if generally known might reasonably be expected to affect materially the value of the subject-matter of that transaction." The liability is to compensate any person who suffers a direct loss as a result of the transaction for the loss suffered by that person, unless the information was known or ought reasonably to have been known to that person at the time of the transaction. The transactions to which the section applies are listed in sub-section (2). They are transactions relating to shares or debentures of the

corporation or a related corporation, interests (within the meaning of section 76) issued by any such corporation, or options to buy or sell any such shares or debentures. Sub-section (3) imposes a limitation period of two years.

5. Sub-section (4) prohibits an officer of a corporation from dealing in options to buy or sell shares or debentures of the corporation or a related corporation, but sub-section (5) allows an officer to obtain from the corporation itself or a related corporation an option to subscribe for shares or debentures and to sell options so acquired.

6. It is to be noted that section 124 and sub-sections (1) (2) and (3) of the proposed section 124A deal with the same general subject matter but in different ways. Under section 124, what is prohibited is making use of information to gain directly or indirectly an "improper" advantage for the officer himself, or to cause detriment to the company. If he gains an improper advantage he is accountable for the profit. If he causes detriment to the company, the section subjects him to a liability to make good the loss suffered by the company. The section does not, however, give any remedy to a third person of whom advantage may be taken. Nor does the section specify what advantages are "improper".

7. The proposed section 124A is more specific. The information must be "special confidential information .... which, if generally known, might reasonably be expected to affect materially the value of the subject-matter." It is limited to transactions relating to shares debentures or interests (including options in respect of shares or debentures). The third person can only sue if he has suffered a "direct loss". Presumably therefore he cannot sue if he sells at the market price to an officer who knows that the price is likely to rise as a result of an announcement about to be made; but in such a case, if the advantage obtained is improper (and we think it would usually be so considered in such a case) the officer must account to the company for the profit under section 124. But it is not clear beyond doubt that the vendor would be held not to have suffered a "direct loss" in such a case. If it were held that he had suffered a direct loss, the officer would be liable twice over, unless, having paid damages to the vendor, he could defend an action by the company by claiming that he had made no profit. If, however, the company claimed first and obtained judgment, he might find himself still unable to resist the claim of the vendor.

8. I t is to be noted that both section 124 and section 124A refer to cases in which the officer is seeking a benefit for himself, and not to cases in which the officer takes advantage of his position to confer a benefit on a third party (e.g., a close relative), though in some circumstances such a case might fall within section 1 24 as conferring an indirect advantage on the officer.

9. Section 124 of the Act was taken from section 107 of the former Victorian Act of 1958. The Jenkins Committee appears to have approved of the principles so laid down (see paragraphs 86,87 and 99 (a) of the Report), although its recommendation was in terms limited to directors, whereas sub-sections (2) (3) and (4) of section 124 of the uniform Act extend to all officers as defined in section 5 of the Act. The recommendation of the Jenkins Committee on this point has not so far been implemented in the United Kingdom. Sub-sections (1) to (3) of section 124A of the G. R. B. seek to

give effect, with some modifications, to the recommendations contained in paragraph 99(b) of the Jenkins Report, and sub-sections (4) and (5) to the recommendation contained in paragraph 99 (c). The former recommendation has not become law in the U. K., but the latter became section 25 of the 1967 Act. A note summarizing the position in the U.S.A., based on a memorandum submitted to the Jenkins Committee in 1961, is attached as Annexure "A".

10. The object of sub-sections (1) to (3) of the proposed section 124A is to alter the law as declared in Percival v. Wright (1902) 2 Ch. 421. It was decided in that case that the director' s fiduciary duty is owed to the company itself and not to the shareholders; and a *fortiori* not to outsiders. We think that an officer who makes use of a specific item of confidential information either to buy shares which he expects will rise when the information is released, or to sell shares which he expects to fall when the information becomes known, has gained an improper advantage from his position, and should be accountable in some way to the extent of that advantage, But as he will be accountable to the company under section 124 in the former case, the question has to be decided whether section 124A should be confined to the latter case. If so, this should be expressly stated. If he is to be accountable to the vendor, in respect of shares which rise in value after release of the information, should he also have to account to the company? On the whole, we are of opinion that the best course is to confine the proposed section 124A to cases in which the outsider is able to show that he suffered a loss by reason of a fall in value, leaving the other case to be dealt with under section 124. It must be borne in mind that while the most common case is that in which an officer buys or sells in anticipation of a favourable or unfavourable announcement, the sections will also cover cases in which the confidential information is not intended to be released, or is not intended to be released for some time. It will usually be difficult for an outsider to prove a case under section 124A, and this will be even more difficult if there is delay in the release of the information. The company, however, will usually be in a better position to discover whether any of its officers have made a secret profit. Moreover, as pointed out above, a vendor of shares who decides to sell at the price of the day before a favourable announcement can hardly be said to have suffered a loss by the action of the officer who bought the shares, since if he had not sold to that officer he would presumably have got a price which was at least no higher than the one he actually received. In such a case it may well be said that the profit should belong to the company whose confidence has been abused.

11. In our view therefore, section 124A should be confined to cases where the outsider suffers a loss by paying a higher price than he would have done if he had known of the "special confidential information" known to the officer.

12. A further question to be dealt with is whether sections 124 and 124A should be confined, as now, to cases where the advantage or benefit is that of the officer himself. Apart from cases in which a member of the officer's family obtains the advantage, there are obviously many cases in which persons having confidential information give "tips" to their friends, who can act on them in circumstances in which the officer himself could not; no doubt

there is an indirect benefit in such cases, since the beneficiary may be expected to return the compliment, but such an indirect benefit would be difficult to prove. In our opinion section 124 should be amended to make it apply where the advantage is obtained by a person other than the officer himself. Although the officer would not have received the advantage, and so would not be liable to account, he would become liable to prosecution under sub-section (3) (b) of section 124.

13. Whether the proposed section 124A should be similarly extended is perhaps more doubtful, but we see no good reason why an officer who misuses special confidential information by telling his friends to sell should not be liable to those who bought from those friends. In such a case he would incur both civil and criminal liability.

14. We wish to emphasize, however, that our concern is more to provide sanctions which will discourage misuse of information than to provide remedies for those who are injured by such conduct.

15. With regard to the form of section 124, we consider that the word "improper" is wrongly placed in the section. An officer is liable to account only for an improper advantage, but there is no requirement of impropriety in relation to detriment. If the opening words were amended to read "An officer .... shall not make improper use of.. .... "the word "improper" could then be dropped where it appears in juxtaposition to the word "advantage". This would indicate that the section was dealing with misuse of information, and not, for example, with cases where an authorized disclosure of information had in fact resulted in detriment to the company.

16. We have considered the question whether section 124 would be improved by modifying the language to bring it into line with the proposed section 124A, i.e., by eliminating the word "improper" and limiting the section to the misuse of "special confidential information". On the whole we do not favour this course. Section 124A is concerned with a specific situation in which special confidential information is misused in relation to transactions of a particular kind. The scope of section 124 is much wider, and subject to the changes suggested above, we think it should be left in its more general form. It would, however, be desirable to substitute the word "corporation" for the word "company" wherever it appears in the section.

17. We have some doubt whether rights in respect of a new issue would be covered by the language of section 124A. We would suggest that the words "a right to acquire or" be inserted before the words "an option" in paragraph (c) of sub-section (2).

SECTION C - DEALINGS IN OPTIONS

18. As stated above, sub-section (4) of the proposed section 124A prohibits dealings in options by officers, except as provided by sub-section (5). With regard to this matter, the Jenkins Committee said (paragraph 90).

"It has been suggested to us, and we agree, that a director of a company should not deal in options in securities of his company

or of the group to which the company belongs. A director who speculates in this way with special inside information is clearly acting improperly, and we do not believe that any reputable director would deal in such options in any circumstances."

The Committee went on to say that it did not think the restriction should extend to options granted to the director by the company or group itself, as this was a matter for the company itself to decide. As an alternative to its recommendation, the Committee suggested that section 195(1), which dealt with the register of directors' shareholdings, should be amended to make it clear that it extends to "put" as well as "call" options.

We do not know whether the Jenkins Committee had in contemplation only options acquired in a regular options market, in which payment is made for a right to call for or to make delivery at a specified price and within a specified time. Section 25 of the U.K. Act of 1967 seems to have interpreted the recommendation in this sense. At all events, in this country there are many companies, especially in the mining field, which have issued options which are traded on Stock Exchanges. The considerations which apply to such options are similar to those applicable to shares. To prohibit directors from transactions relating to such options, while allowing them to buy or sell shares (subject to the provisions of sections 124 and 124A) would, we think, be to impose an undue limitation on the freedom of action of directors. In relation to options, we think the observation of the Cohen Committee on share transactions is relevant. The Cohen Committee, as quoted in paragraph 88 of the Jenkins Committee, said:

"The best safeguard against improper transactions by directors and against unfounded suspicions of such transactions is to ensure that disclosure is made of all their transactions in the shares or debentures of their companies ...."

19. In our view, if proper disclosure is made of any transactions relating to options, any improper dealing can be left to be dealt with under sections 124 and 124A.

SECTION D - DISCLOSURE BY DIRECTORS

20. As we have indicated above, we agree with the view of the Cohen Committee that the best safeguard against improper transactions is to ensure that disclosure is made of all transactions. Section 126 of the Act requires the company to keep a register of directors' holdings of shares or debentures which are held by or in trust for him "or of which he has any right to become the holder (whether on payment or not)". Section 127 requires the director to give notice to the company of such matters relating to himself as may be necessary for the purposes of section 126. The register is open for inspection by members and debenture holders for a specified period before and after the annual general meeting (section 126 (6)). It is proposed by the G.R.B. that the register shall be continuously available for inspection, in the case of members without charge, and of any other person on payment of a fee (see G.R.B. section 13 (g)). We agree with this proposal.

21. Paragraph (d) of section 13 of the G. R. B. proposes an extension of the obligation of the director to disclose his holdings, by adding after the words "(whether on payment or not)" the words "or in which he has, directly or indirectly, any beneficial interest (including an interest which is reversionary or contingent or which arises as a result of a discretionary trust)". While we agree with

this extension, we do not think it goes far enough. For example, it is obvious that the holdings of companies controlled by a director or in which he has a substantial interest should be included. The draft bill prepared to deal with disclosure of substantial shareholdings contains provisions of this kind, and somewhat similar criteria could no doubt be adopted. We have not given detailed consideration to the question how far these criteria would be appropriate, but we would be happy to submit a draft if the general principle is approved. It is to be noted that in the U. K. Act of 1967, the rules for determining whether a person is interested in shares were in the first instance made applicable to directors (section 28) and then incorporated in the provisions relating to substantial shareholdings (section 33). We think that sub-section (1)

of section 126 should also be amended to make it clear that it extends to "interests" within the meaning of section 76 of the Act, and to options of all kinds, including "put" options.

22. Since we are dealing with the proposals for amendment of section 126, we should add that we approve also of the amendments proposed to be made by paragraphs (e) (f) (g) (so far as not mentioned above) (h) (i) and (k) of section 13 of the G.R.B, draft of 21.5.1969. This includes some amendments to section 127 also, with which we have not dealt in previous reports. The reference to section 184 in paragraph (i) will require amendment in the light of the draft prepared to deal with takeovers.

23. We should add that we have not overlooked the fact that, whereas section 124 and the proposed section 124A refer to "officers", the requirements of section 126 as to disclosure are confined to directors, although we have no reason to believe that the evil aimed at is confined to directors. However, having regard to the width of the definition of the term "officer", we do not feel that the additional administrative burdens which would be involved would be justified by any benefits which would accrue from an attempt to require all officers of a corporation to disclose their interests in shares in the corporation or changes in those interests.

SECTION E - SUMMARY OF RECOMMENDATIONS

24. Our principal recommendations may be summarized as follows:

(a) Section 1 24 (2) should be amended by deleting the word "improper" where it now appears before the word "advantage" and inserting the word "improper" between "make" and "use".

(b) Section 1 24 should also be amended by substituting the word "corporation" for "company" wherever appearing.

(c) Subject to the changes mentioned below, we recommend the adoption of the proposed section 124A sub-sections (1) (2) and (3).

(d) Section 1 24A should be so expressed as to make it clear that it only applies to cases of outsiders who pay more than the true value, in ignorance of unfavourable information.

(e) Both sections 124 and the proposed section 124A should be extended to cases in which persons other than the officer of the corporation receive an advantage from the use of information.

(f) Section 124A (2) should be amended to include a reference to "rights".

(g) We do not recommend the adoption of sub-sections (4) and (5) of the proposed section 124A.

(h) The obligations imposed as to disclosure of directors' shareholdings by section 126 of the Act should be extended to cases in which the director is indirectly interested, using somewhat similar criteria to those adopted in the draft bill dealing with "substantial share-holdings"; "interests" and options of all kinds should also be included.

(i) The proposals for amendment of sections 126 and 127 of the Act as contained in the G.R.B. draft of 21st May 1969 should be adopted, subject to the modifications suggested in paragraph (h) above.

R.M. EGGLESTON,

J.M. RODD,

P.C.E. COX.

20th February 1970.

ANNEXURE "A"

REGULATION OF INSIDER TRADING IN THE U.S.A.*

S. 16 (a) of the Securities Exchange Act 1934 requires that details of holdings and share-dealings shall be filed both with the S. E. C. and with the Stock Exchange by any officer, director or any person" 'who is directly or indirectly the beneficial owner of more than 10% of any class of equity security' of the company". (As compared with section 195 of the U.K. Act, the range of persons whose dealings are affected is wider and the information provided is always available for public inspection. The Government Printing Office published the information in all reports in a monthly pamphlet which has a wide circulation. "This in itself puts some teeth in the section in contrast with the British one. ") S. 16 (b) provides that any profit made within a period of six months must be accounted for to the company whether or not there has been disclosure under s. 16 (a). Either the company or any member of it on behalf of the company may institute proceedings to recover if the insider does not voluntarily disgorge. "I n interpreting these provisions the Courts have held that the section applies whether or not there has in fact been any misuse of inside information and that profits are calculated by matching the lowest price in with the highest price out during any period of six months." It is to be noted that "amounts due from officers, directors and their nominees and associates" must be indicated in management' s proxy statement and that the item has been held to include amounts due under s. 16 (b).

Rule 10B-5 under the Act provides:

"It shall be unlawful for any person directly or indirectly ......

(1) to employ any device scheme or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, not misleading, or

* Taken from a summary, prepared for the Company Law Advisory Committee, of a memorandum submitted to the Jenkins Committee.

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit on any persons, in connection with the purchase or sale of any security."

It has been held that this rule requires an "insider" to disclose material facts known to him by virtue of his inside position, but not known to a selling shareholder, which would affect the judgment of the sellers. The same, it has been held, applies if the insider

sells rather than buys. Whilst case law suggested that the American Courts would not be prepared to follow Percival v. Wright (1902) 2 Ch. 421, this rule sealed the position. "It is therefore almost true to say that sales and purchases by insiders have become contracts of the utmost good faith demanding disclosure of all material facts."

"If rules similar to these were adopted in Britain it would undoubtedly be a potent sanction against abuse of inside information.

Annexure "A"

Not only would the insider have to account to the company for any short-swing profits on dealings in the company' s securities, but, if he bought or sold with inside information (for example, of a takeover bid or a forthcoming dividend distribution), he might be liable to the other party to the transaction."

ANNEXURE "B"

SECTION 124A OF THE GENERAL REVISION BILL

New S. 124A Trading by officers in securities and options.

(b) After section 124 there shall be inserted the following section:

"124A. (1) An officer of a corporation who, in any transaction to which this section applies, makes use for his own benefit or behalf of any special confidential information which he acquired in his capacity as an officer and which, if generally known, might reasonably be expected to affect materially the value of the subject-matter of that transaction, shall be liable to pay any person who suffers a direct loss as a result of the transaction for the loss suffered by that person unless the information was known or ought reasonably to have been known to that person at the time of the transaction.

(2) The transactions to which this section applies are transactions relating to:

(a) shares in or debentures of any corporation of which the officer is an officer or of any corporation which is deemed by virtue of sub-section (5)of section 6 to be related to the corporation;

(b) interests within the meaning of section 76 issued by any such corporation; or

(c) an option to buy or sell any such shares or debentures.

(3) An action under sub-section (1) shall be commenced within two years after the date of completion of the transaction.

(4) An officer of a corporation shall not accept buy sell or enter into any contract relating to an option to buy or sell shares in or debentures of the corporation of which he is an officer or of any corporation which is by virtue of sub-section (5) of section 6 deemed to be related to the corporation.

(5) Nothing in this section shall prevent the accepting or buying by an officer of a corporation from the corporation or from any corporation which is by virtue of sub-section (5) of section 6 deemed to be related to the corporation of any option to subscribe for shares in or debentures of the corporation or the sale of the options which are accepted or bought.

Penalty: $100.";

V.C.N. Blight, Government Printer, New South Wales 1970