

False Trading and Market Rigging in Australia

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One of the key corporate regulatory issues in Australia arising from the global financial crisis is whether the market misconduct provisions in Part 7.10 Division 2 of the Corporations Act 2001 (Cth) are effective. Recent events have demonstrated the importance of protecting stock markets against manipulation, given the repercussions for the economy and community more generally. However, the Commonwealth Treasury identified problems with the false trading and market rigging provisions in section 1041B of the Act back in 2007. This paper analyses the provision and proposes urgent reform to this important area of law.

Introduction

The global financial crisis has resulted in an extended period of turmoil and uncertainty in world financial markets. This has provided an environment in which significant financial gains can be made through the manipulation of stock markets. Much attention has been given to the effect of short selling and the use of use of false rumours to depress share prices (a practice currently known as ‘rumourage’).¹ In response, the Minister for Superannuation and Corporate Law has asked the Companies and Markets Advisory Committee (CAMAC) to report by 30 June 2009 on a comparison of overseas regulation of the spread of false or misleading information, and on whether changes are required to Australia’s regulatory framework.² Although the Terms of Reference for CAMAC’s review refer to other market misconduct provisions, including the separate prohibition on false trading and market rigging provisions in section 1041B of the *Corporations Act 2001* (Cth) (*Corporations Act*), CAMAC has been asked to ‘review the regulatory regime governing market manipulation, with specific focus on the spreading of false information’.³

It is equally important that section 1041B of the *Corporations Act* operates effectively. Subsection 1041B(1) prohibits conduct that is likely to create a false or misleading appearance in relation to three matters. That is, there must not be a false or

¹ In March 2008, the Australian Securities and Investments Commission (ASIC) issued a media release warning market participants against the use of such practices: ASIC, *False or Misleading Rumours*, Media Release 08-47, 6 March 2008 <<http://www.asic.gov.au/asic/asic.nsf/byheadline/08-47+False+or+misleading+rumours?openDocument>> accessed 12 January 2009. A similar practice was previously referred to as a ‘run’, where rumours were used in a strong market to increase share prices and allow organisers to sell their shares for a profit: see Senate Select Committee on Securities and Exchange, *Australian Securities Markets and their Regulation* (1974) (Rae Report), Pt 1, Vol 1, pp 8.5-8.6.

² Minister for Superannuation and Corporate Law, Letter to Companies and Markets Advisory Committee Convenor, 19 November 2008 (Market Integrity Review Terms of Reference), pp 4-5 <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/\\$file/Ref_Market_Volatility.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/$file/Ref_Market_Volatility.pdf)> accessed 12 January 2009.

³ *Ibid*, p 4. See also Minister for Superannuation and Corporate Law, *Action to Further Enhance Market Integrity*, Press Release No 80, 19 November 2008, p 2 <[http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/\\$file/Press_Release_Market_Volatility.pdf](http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFReference/$file/Press_Release_Market_Volatility.pdf)>, accessed 12 January 2009.

misleading appearance of active trading, with respect to the market for financial products (which include shares quoted on the Australian Stock Exchange), or with respect to their price.⁴ By misleading unsuspecting investors into believing that there is additional market activity and/or that price movements are real, practices involving false trading and market rigging pose a major threat to the fairness and efficiency of markets.⁵

Despite an absence of empirical evidence on the frequency of manipulative practices in the market, there is little doubt that they exist.⁶ The case law provides stark examples of this behaviour, such as an audacious attempt recorded in *ASIC v Nomura International plc*⁷ (*Nomura*) to sell securities worth nearly \$600 million at or shortly before the close of the market in order to profit from futures contracts based upon share prices. Two practices that are particularly relevant to section 1041B were emphasised in the 1974 Parliamentary Committee report entitled *Australian Securities Markets and their Regulation*.⁸ The first is a ‘pool’, in which a group of investors sell shares to each other to increase turnover and price, in order to create the impression of increased interest in the shares and sell their holdings at a profit.⁹ Another practice, referred to as ‘churning’, involves the placing of buying and selling orders at the same or slightly rising prices.¹⁰ Both practices encourage unsuspecting investors to purchase the shares and allows the perpetrators to sell at a profit.¹¹ This behaviour is clearly unfair to other market participants. It also impedes market efficiency as the artificial transactions affect the supply of and demand for the financial product.¹² The information upon which a properly performing market depends is similarly distorted as investors take into account false market movements in making their investment decisions.¹³

It is notoriously difficult to prove the intention or other mental element necessary to secure a criminal conviction in relation to the creation of a false or misleading

⁴ *Corporations Act 2001* (Cth), ss 761A ‘security’ (para (a)), 764A(1)(a). Although the market misconduct provisions apply to financial products, this paper will focus on the effect of this conduct on stock markets in particular.

⁵ See, for example, V Goldwasser, ‘Regulating Manipulation in Securities Markets: Historical Perspectives and Policy Rationales’ (1999) 5 *Australian Journal of Legal History* 149 at 198. See also text accompanying n 11 below.

⁶ See Goldwasser, above n 5, at 187-188; House of Representatives Standing Committee on Legal and Constitutional Affairs, *Corporate Practices and the Rights of Shareholders* (1991), para 2.5.18, Rae Report, above n 1, p 8.1.

⁷ (1998) 160 ALR 246. In that case, Sackville J found breaches of section 998 of the Corporations Law (the predecessor to section 1041B of the *Corporations Act*), amongst other provisions: at 357.

⁸ Rae Report, above n 1, Ch 8. Examples of other manipulative practices are referred to in Australian Stock Exchange Ltd, *Circular to Member Organisations*, 21 June 1990 cited in P Redmond, *Companies and Securities Law Commentary and Materials* (Fifth Edition, Thomson Reuters, Sydney 2009), pp 757-758.

⁹ Rae Report, above n 1, pp 8.1-8.2.

¹⁰ *Ibid*, p 8.2.

¹¹ *Ibid*, p 8.3. These practices could similarly be used to place downward pressure on prices in the context of a falling market, in order to generate profits through short selling. The detailed regulation of short selling, which has been recently amended through the *Corporations Amendment (Short Selling) Act 2008* (Cth), is beyond the scope of this paper.

¹² As observed in *North v Marra Developments Ltd* (1981) 148 CLR 42 (*North*), it is important that ‘the market reflects the forces of genuine supply and demand’: at 59 (per Mason J).

¹³ See, for example, *US v Brown* 79 F 2d 321 at 325 (2d Cir, 1935), *Thornton v SEC* 171 F 2d 702 (2d Cir, 1948) cited in A Black, ‘Regulation Market Manipulation: Sections 997-999 of the Corporations Law’ (1996) 70 *Australian Law Journal* 987 at 998-999.

appearance concerning the market under subsection 1041B(1). The legislature has sought to ameliorate this in two ways. First, subsection 1041B(2) deems that a person is taken to have created a false or misleading appearance of active trading in two specific situations. The first situation is where a transaction does not involve any change in beneficial ownership, either because the same person or their associate has an interest in the shares following the transaction.¹⁴ In the second situation, there is a countervailing offer to buy or sell for substantially the same number of shares at substantially the same price.¹⁵ These two strategies are also referred to as ‘wash sales’ and ‘matched orders’ respectively, particularly in the United States.¹⁶ Secondly, the civil penalty regime in Part 9.4B of the *Corporations Act* was applied to certain market misconduct offences (including section 1041B) under the *Financial Services Reform Act 2001* (Cth) (*FSR Act*).¹⁷ This provides an additional sanction which is easier to establish given the civil burden of proof, and is thus less costly in terms of the use of regulatory resources.¹⁸

However, the false trading and market rigging provisions as currently drafted are not clear in their operation in several important respects. This needs to be remedied as a matter of urgency given the importance of ensuring that the obligations of market participants can be enforced, particularly in the light of recent economic and market conditions. Although difficulties with the provisions have been known for some time, neither the previous nor the current Government have implemented reforms to resolve them. In March 2007, the Commonwealth Treasury sought comments on a wide range of issues arising from the use of criminal, civil and administrative sanctions in corporate law in its Discussion Paper entitled *Review of Sanctions in Corporate Law* (Discussion Paper).¹⁹ The Discussion Paper also focused on a handful of provisions in the final chapter entitled ‘Better Defining the Contravention’. Of these, section 1041B was the only market misconduct provision singled out for mention. The Discussion Paper sought comments on potential amendments to the provision to clarify its operation in light of the *Criminal Code Act 1995* (Cth) (Criminal Code) and also in relation to the circumstances in which civil liability can be incurred under Part 9.4B of the *Corporations Act*.

This paper analyses the effectiveness of section 1041B and proposes reform to better achieve its aims. The following part examines the previous legislative and judicial approaches taken in relation to the false trading and market rigging provisions. In the second part, the current operation of section 1041B is discussed with a particular focus upon the application of the Criminal Code. The third part analyses the desirability of amendments suggested in the Discussion Paper and proposes reform in relation to the criminal offence and civil provisions. Finally, the conclusion builds

¹⁴ *Corporations Act 2001* (Cth), s 1041B(2)(a), (3).

¹⁵ *Corporations Act 2001* (Cth), s 1041B(2)(b).

¹⁶ See Explanatory Memorandum, Securities Industry Bill 1980, pp 119-120; *Securities Exchange Act 1934* (US), s 9(a)(1)(A), (B). See also Black, above n 13, at 998-1000; P Meyer, ‘Fraud and Manipulation in Securities Markets: A Critical Analysis of Sections 123 to 127 of the Securities Industry Codes’ (1986) *Company and Securities Law Journal* 92 at 94.

¹⁷ *Financial Services Reform Act 2001* (Cth) (*FSR Act*), Sch 1, Pt 1, item 1 (ss 1041A-1041D), Sch 1, Pt 2, items 436-437.

¹⁸ Revised Explanatory Memorandum, Senate, Financial Services Reform Bill 2001 (Cth), pp 16-17, 24, 174-176.

¹⁹ Department of the Treasury, *Review of Sanctions in Corporate Law*, Commonwealth of Australia, 5 March 2007, <<http://www.treasury.gov.au/contentitem.asp?NavId=037&ContentID=1182>> accessed 11 August 2008.

upon these proposals for reform by highlighting further issues that need to be considered in relation to market misconduct more generally.

History of the False Trading and Market Rigging Provisions

Australia's first provision on false trading and markets can be traced back to the *State Securities Industry Acts* of 1970 and 1971.²⁰ As in the case of other market misconduct provisions, it was based upon a similar provision in the United States.²¹ Section 70 of the *Securities Industry Act 1970* (NSW) (1970 Act) contained the following offence:

A person shall not create or cause to be created or do anything which is calculated to create, a false or misleading appearance of active trading in any securities on any stock market in the State, or a false or misleading appearance with respect to the market for, or the price of, any securities.

The key elements of this prohibition, namely the false or misleading appearance of active trading or relating to the market or price, have not been changed in subsequent successive reforms. In *North v Marra Developments Ltd*²² (*North*), Mason J (with whom the other members of the High Court agreed on this issue) made a series of important conclusions in relation to the operation of section 70. In particular, Mason J's judgment indicates that there must be an element of intention in the conduct caught by the section:²³

[T]he statutory prohibition is directed against activity which is designed to give the market for securities or the price of securities a false or misleading appearance. In this setting, 'calculated' means 'designed' or 'intended' rather than 'adapted' or 'suited'. It is not altogether easy to translate the generality of this language into a specific prohibition against injurious activity, whilst at the same time leaving people free to engage in legitimate commercial activity which will have an effect on the market and on the price of securities. Purchases or sales are often made for indirect or collateral motives, in circumstances where the transactions will, to the knowledge of the participants, have an effect on the market for, or the price of, shares. Plainly enough it is not the object of the section to outlaw all such transactions.²⁴

In determining which transactions are outlawed, Mason J focussed upon what he considered to be the purpose of the provision:

It seems to me that the object of the section is to protect the market for securities against activities which will result in artificial or managed manipulation. The section 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

²⁰ For a detailed discussion of the historical context of the provisions, see Goldwasser, above n 5, at 166-172.

²¹ See above n 16.

²² (1981) 148 CLR 42 at 47-48 (per Stephen and Aickin JJ), at 58-59 (per Mason CJ), at 61 (per Murphy and Wilson JJ).

²³ See also Meyer, above n 16, at 97.

²⁴ *North* at 58-59 (per Mason J).

purpose of setting or maintaining the market price. It is in the interests of the community that the market for securities should be real and genuine, free from manipulation. The section is a legislative measure designed to ensure such a market and it should be interpreted accordingly.²⁵

Mason J also agreed with the majority of the NSW Court of Appeal in the same case²⁶ that section 70 did not only apply to ‘fictitious or colourable’ transactions:

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.²⁷

Although Mason J’s views on intention are no longer supported by the current law,²⁸ his comments on the nature of the transactions covered by the prohibition (particularly in relation to ensuring ‘genuine supply and demand’) have often been cited in regard to the subsequent legislation.²⁹ Significant changes were incorporated in the *Securities Industry Act 1980* (Cth) (1980 Act), which was applied by the States in separate legislation.³⁰ Apart from some minor drafting changes,³¹ the prohibition in subsection 124(1) of the 1980 Act was the same in substance as section 70 of the 1970 Act.

There were two important additions in section 124 of the 1980 Act compared to section 70 of the 1970 Act. First, subsection 124(3) deemed certain transactions to have created a false or misleading appearance of active trading in securities under the prohibition in subsection 124(1). The circumstances in which the deeming provisions operated are substantially the same as currently apply in subsection 1041B(2) of the *Corporations Act* in relation to financial products. That is, the deeming provisions apply where there is a transaction that does not involve any change in beneficial ownership (including where an associate has an interest in the products after the transaction), or where a person offers to acquire or dispose of financial products where they have (or know that an associate has) made or propose to make an offer to dispose of or acquire substantially the same number of those products at substantially the same price. The second key difference was the inclusion of the following defence in subsection 124(4) of the 1980 Act:

²⁵ *North* at 59 (per Mason J).

²⁶ *North v Marra Developments Ltd* [1979] 2 NSWLR 887 at 899 (per Hope and Samuels JJA).

²⁷ *North* at 59 (per Mason J).

²⁸ See below nn 32 and 38, and accompanying text.

²⁹ The most recent of these cases are on section 998 of the Corporations Law: see, for example, *Manasseh v R* (2002) 40 ACSR 593 (*Manasseh*) at 606-607 (per Sheller JA), at 618 (per Simpson JA), at 618 (per Howie JA); *Fame Decorator Agencies Pty Ltd v Jeffries Industries Ltd* (1998) 28 ACSR 58 at 62 (per Gleeson CJ), at 65 per Powell JA.

³⁰ See, for example, *Securities Industry (Application of Laws) Act 1981* (NSW). Similar changes were also made in the State legislation preceding the 1980 Act: see *Securities Industry Act 1975*, s 109; G Hart, ‘The Regulation of Stock Market Manipulation’ (1979) *Australian Business Law Review* 139.

³¹ The only substantive difference is the application of the prohibition in the 1980 Act to acts outside the jurisdiction.

In a prosecution of a person for an act referred to in subsection (3), it is a defence if the defendant establishes that the purpose or purposes for which he did the act was not, or did not include, the purpose of creating a false or misleading appearance of active trading in securities on a stock market.

The introduction of the deeming and defence provisions led to a shift away from Mason J's view that intention was a necessary ingredient in the offence. In *Endresz v Whitehouse*,³² Hansen J made the following obiter finding:

While proof of the commission of an offence against s 124(1), standing alone, may be taken as requiring proof by the informant of the necessary mens rea of the defendant, where [the deeming provision in] s 124(3)(a) applies, the necessity of proving this element is removed ... [T]he defence in s 124(4) ... makes consideration of the element of intention or purpose relevant to a charge under s 124(1) where the deeming provisions contained in s 124(3) apply, but only in terms of the defendant establishing that the purpose was not or did not include the purpose of creating a false or misleading appearance of active trading.³³

There were few changes in the subsequent false market and market rigging provisions in section 998 of the Corporations Law. Importantly, section 998 of the Corporations Law included deeming and defence provisions based upon those in section 124 of the 1980 Act, with only a few substantive amendments made to the provision.³⁴ First, the opening words of subsection 998(1) stated that '[a] person must not create, or do anything that is intended or likely to create' the requisite false or misleading appearance. This introduced the concept of likelihood into the offence, replacing the prohibition against 'causing to create' such an appearance in subsection 124(1).³⁵ Secondly, a number of minor changes were made to the deeming provisions in subsection 998(5).³⁶

The Federal Court's decision in *Nomura*³⁷ made it clear that intention is only one of three possible alternatives in establishing an offence under the opening words of subsection 998(1) cited above.³⁸ With respect to the last of these alternatives, Sackville J considered that the meaning of 'likely' was 'more probable than not'.³⁹ In obiter, Sackville J did not think that it was necessary to prove that the alleged

³² (1994) 14 ACSR 31.

³³ *Endresz v Whitehouse* (1994) 14 ACSR 31 at 40. An appeal against this decision was dismissed by the Full Court of the Supreme Court of Victoria in *Endresz v Whitehouse* [1998] 3 VR 461, without comment on Hansen J's conclusion cited above.

³⁴ The prohibition against acts within or outside the jurisdiction in subsection 124(1) was not included in section 998(1) because of the national coverage of the scheme: see, for example, Corporations Law, s 8(1) and n 53 below.

³⁵ Similarly, the reference to causing an offer to be made in the deeming provision in s 124(3)(b), (c) of the 1980 Act did not appear in the equivalent deeming provisions in Corporations Law s 998(5)(b), (c).

³⁶ The most significant of these was the amendment to section 998(5)(a) to apply where a person 'enters into, or carries out' a transaction that did not involve any change in beneficial ownership (rather than when a person 'effects, takes part in, is concerned in or carries out' such a transaction). See also n 35 above.

³⁷ See above n 7 and accompanying text.

³⁸ *ASIC v Nomura International plc* (1998) 160 ALR 246 (*Nomura*) at 334 (per Sackville J). See also V Goldwasser, 'Market Rigging after *Nomura*' (1999) 17 *Company and Securities Law Journal* 44 at 47.

³⁹ *Nomura* at 338.

contravener was aware that the conduct would be likely to have a false or misleading appearance, although he did not express a final view on this.⁴⁰ Sackville J found contraventions of both section 998 and the false trading and market rigging provisions applying to futures contracts in section 1260 of the Corporations Law.⁴¹

It is also worth noting that the market misconduct provisions applying to securities contained a second prohibition against purchases or sales not involving a change in beneficial ownership, where they maintained, increased, reduced, or caused fluctuations in the market price of any securities.⁴² Introduced in the first limb of subsection 72(2) of the 1970 Act, this part of the provision was substantially the same in subsection 124(2) of the 1980 Act and subsection 998(3) of the Corporations Law. Interestingly, the 1980 Act and Corporations Law provisions also included a defence corresponding to that in subsection 124(4) as set out above.⁴³ That is, it was a defence in a prosecution if the defendant established that their purpose(s) did not include the purpose of ‘creating a false or misleading appearance with respect to the market for, or price of, securities.’ Neither the second prohibition against transactions involving no change of beneficial ownership nor the defence relating to it appear in the current market misconduct provisions in the *Corporations Act*. Apparently based upon the absence of similar provisions applying to futures contracts,⁴⁴ this avoids duplication given the subsection 1041B(1) prohibition against false or misleading appearances and the paragraph 1041B(2)(a) deeming provision where there is no change in beneficial ownership.

The Current Provisions

The false trading and market rigging provisions were amended again by the *Financial Services Reform Act 2001* (Cth) (FSR Act). One of the key reforms was the application of the civil penalty provisions in Part 9.4B to certain market misconduct provisions, including the false trading and market rigging provisions in section 1041B. This reflected a concern that it was too difficult and costly for the law to be enforced using the criminal standard of proof, and that it would consequently be more efficient and appropriate for the corporate regulator to have access to civil sanctions.⁴⁵

As a result, civil penalty proceedings can be brought based upon a contravention of the elements of section 1041B(1),⁴⁶ using the civil standard of the balance of probabilities and without the need to establish intention or other fault.⁴⁷ Under the

⁴⁰ Ibid at 348.

⁴¹ Ibid at 357. The provision applying to futures contracts in section 1260(1) of the Corporations Law was substantially the same as current section 1041B(1), but did not have any deeming, defence or other associated provisions: see *ibid* at 348-349.

⁴² See Corporations Law, s 998(3).

⁴³ See above text preceding n 32.

⁴⁴ Revised Explanatory Memorandum, Senate, Financial Services Reform Bill 2001 (Cth), p 176.

⁴⁵ Ibid, pp 16-17.

⁴⁶ See *Ibid*; *Corporations Act 2001* (Cth), Part 9.4B (particularly s 1317E(1)(j)).

⁴⁷ See, for example, *Donald v ASIC* (2000) 35 ACSR 383, which involved ASIC and Administrative Appeals Tribunal decisions to ban a person from acting as a securities dealer representative based upon a contravention of subsection 998(1) of the Corporations Law. Heerey J concluded that the decision maker was not required to find that the person ‘knew or had in mind at the time of the contravening conduct that a false and misleading appearance were likely to be created by that conduct’: at 392 (per Heerey J). See also Australian Law Reform Commission, Report No 95, *Principled Regulation*:

civil penalty provisions in Part 9.4B of the *Corporations Act*, a person who has contravened subsection 1041B(1) can be subject to a pecuniary penalty order of up to \$200,000 for an individual (or \$1 million for a body corporate), in addition to possible orders to compensate other persons for damage resulting from the contravention.⁴⁸ This can be contrasted with the maximum penalty of \$22,000 for an individual (or \$110,000 for a body corporate) and/or five years imprisonment for the criminal provision.⁴⁹ This is similar to the penalty that applied under the Corporations Law,⁵⁰ and is not much more than the penalty that applied for a breach of section 70 of the 1970 Act.⁵¹ It is incongruous that the maximum fine applying to a criminal breach of the provision is only a tenth of the possible penalty payable as part of a civil sanction.

Prohibition in section 1041B(1)

Consistent with the overall aim of the FSR Act to provide a uniform scheme of regulation for comparable products,⁵² current section 1041B of the *Corporations Act* applies to all financial products. The resulting provision is an amalgam of the previous provisions applying to securities and futures contracts under subsections 998(1) and 1260(1) of the Corporations Law. The text of section 1041B(1) reads:

A person must not do, or omit to do, an act (whether in this jurisdiction or elsewhere) if that act or omission has or is likely to have the effect of creating, or causing the creation of, a false or misleading appearance:

- (a) of active trading in financial products on a financial market operated in this jurisdiction; or
- (b) with respect to the market for, or the price for trading in, financial products on a financial market operated in this jurisdiction.

There are a number of notable differences between section 1041B(1) and its Corporations Law predecessors. First, omissions are included as a basis for an offence. Secondly, the prohibition clearly applies to acts or omissions outside Australia.⁵³ Thirdly, the reference to intention in subsection 998(1) has been removed. Finally, the concept of a transaction being ‘likely to have the effect of creating or causing the creation of’ a false or misleading appearance has been adopted instead.

Federal Civil and Administrative Penalties in Australia, December 2002, pp 117-118, <<http://www.austlii.edu.au/au/other/alrc/publications/reports/95/>> accessed 12 January 2009.

⁴⁸ *Corporations Act 2001* (Cth), ss 1317DA, 1317E(1)(jc), 1317G(1A)-(1B), 1317HA(1). Such damage includes any profits made by any person as a result of the contravention: s 1317HA(2).

⁴⁹ *Corporations Act 2001* (Cth), ss 1311(1)-(1A), 1312, Schedule 3 item 309C; *Crimes Act 1914* (Cth), s 4AA.

⁵⁰ Although the Schedule 3 penalty was expressed in the same terms, the maximum penalties under the Corporations Law were \$20,000 for an individual and \$100,000 for a body corporate due to the lower value of a penalty unit at that time: see Corporations Law, ss 9 (‘penalty unit’), 1311(3), 1312, Sch 3.

⁵¹ *Securities Industry Act 1970* (NSW), s 74. The penalty applicable in the 1980 Act was \$20,000 for an individual and \$50,000 for a body corporate: *Securities Industry Act 1980* (Cth) (1980 Act), s 129.

⁵² Revised Explanatory Memorandum, Senate, Financial Services Reform Bill 2001 (Cth), p 1.

⁵³ There was no provision specifically giving extraterritorial effect to section 998: cf Corporations Law ss 110D (Chapters 1-6, 9), 1002 (Chapter 7.11 Division 2A). However, this was not considered to be conclusive and it was arguable that Corporations Law section 1313A relating to offences committed partly in and partly out the jurisdiction could have extraterritorial effect: see Black, above n 13, 1002-1004.

Although wording in subsection 1041B(1) does not refer to intention, this is one of the possible mental elements that needs to be established under the Criminal Code.

Applying from 15 December 2001, the Criminal Code requires that in order for a person to have been found guilty of an offence both the physical elements required by the offence and a corresponding fault element for each physical element must be proved beyond reasonable doubt.⁵⁴ Physical elements comprise conduct, a result of conduct or a circumstance in which conduct (or the result of conduct) occurs.⁵⁵ There are four possible fault elements, namely intention, knowledge, recklessness or negligence.⁵⁶ Unless the offence itself specifies the applicable fault element, the Code provides that intention is the fault element for conduct and either intention, knowledge or recklessness can be used where the physical element comprises a circumstance or result.⁵⁷ These default elements apply in this case because section 1041B does not specify any fault elements.

Consequently, in order to establish an offence under subsection 1041B(1), it must first be proved that the person has done, or omitted to do, an act intentionally. Secondly, it must be shown that this was likely to have the effect of creating, or causing the creation of, the requisite false or misleading appearance. As this effect is a result of the person's conduct, the fault element that must be established in relation to this result is intention, knowledge or recklessness.⁵⁸ Intention would require that the person meant to bring about the result or was aware that it would occur in the ordinary course of events.⁵⁹ Knowledge requires that the person was aware that the result existed or would exist in the ordinary course of events.⁶⁰ Recklessness would require that the person was aware of a substantial risk that the result would occur and, having regard to the circumstances known to them, it was unjustifiable to take that risk.⁶¹

This demonstrates that, although the act (presumably of entering into the relevant transaction(s)) would need to be intentional, it would not necessarily need to be established that the defendant intended the likely effect of causing the creation of a false or misleading appearance in relation to the market. At a minimum, it need only be established that they were aware of the substantial risk of this occurring and that, as a matter of fact, that it was unjustifiable to take that risk.⁶²

Deeming provisions in subsection 1041B(2)

The application of the Criminal Code to the deeming provisions in subsection 1041B(2) raises more significant issues. Subsection 1041B(2) states that:

For the purposes of subsection (1), a person is taken to have created a false or misleading appearance of active trading in particular financial products on a financial market if the person:

⁵⁴ *Criminal Code Act 1995* (Cth) (Criminal Code), ss 2.2(2), 3.2, 13.1(1), 13.2(1).

⁵⁵ Criminal Code, s 4.1(1).

⁵⁶ Criminal Code, s 5.1(1).

⁵⁷ Criminal Code, ss 5.4(4), 5.6.

⁵⁸ See n 57 above and accompanying text.

⁵⁹ Criminal Code, s 5.2(3).

⁶⁰ Criminal Code, s 5.3.

⁶¹ Criminal Code, s 5.4(2).

⁶² Criminal Code, s 5.4(3).

- (a) enters into, or carries out, either directly or indirectly, any transaction of acquisition or disposal of any of those financial products that does not involve any change in the beneficial ownership of the products; or
 - (b) makes an offer (the *regulated offer*) to acquire or to dispose of any of those financial products in the following circumstances:
 - (i) the offer is to acquire or to dispose of at a specified price; and
 - (ii) the person has made or proposes to make, or knows that an associate of the person has made or proposes to make:
 - (A) if the regulated offer is an offer to acquire—an offer to dispose of; or
 - (B) if the regulated offer is an offer to dispose of—an offer to acquire;
- the same number, or substantially the same number, of those financial products at a price that is substantially the same as the price referred to in subparagraph (i).

This subsection provides two additional way of establishing a false or misleading appearance of active trading under subsection 1041B(1).⁶³ There are also two further subsections expanding upon paragraph 1041B(2)(a). First, subsection 1041B(3) provides that a transaction does not involve a change in beneficial ownership if the person or their associate has an interest in the financial products after the acquisition or disposal.⁶⁴ Secondly, under subsection 1041B(4), a reference to such a transaction includes the making of an offer to acquire or dispose of financial products, or where a person is invited (expressly or impliedly) to offer to acquire or dispose of such products. Both of these subsections originated from earlier versions of the false trading and market rigging provisions.⁶⁵

Applying the Criminal Code to the deeming provision in paragraph 1041B(2)(a), it would need to be established that the person entered into or carried out a transaction of acquisition or disposal of financial products intentionally. In addition, it would need to be shown that the person was reckless, had knowledge of or intended the circumstance that the transaction did not involve a change in the beneficial ownership of the financial products.⁶⁶ Similarly to that discussed above,⁶⁷ recklessness would require the person to be aware of a substantial risk that that circumstance existed or would exist and, having regard to the circumstances known to them, it was

⁶³ See *Corporations Act 2001* (Cth), Note to s 1041B(2).

⁶⁴ For a discussion of the predecessor provision in subsection 998(7), see *Manasseh* at 614-617 (per Sheller JA).

⁶⁵ For earlier versions of subsection 1041B(3) of the *Corporations Act 2001* (Cth), see *Securities Industry Act 1970* (NSW), s 72(2); *Securities Industry Act 1980* (Cth), s 124(5) and *Corporations Law*, s 998(7). Earlier versions of subsection 1041B(4) of the *Corporations Act* appeared in *Securities Industry Act 1980* (Cth), s 123(4) and *Corporations Law*, s 998(9).

⁶⁶ See also *Corporations Act 2001* (Cth), s 1041B(3)-(4).

⁶⁷ See above text accompanying n 61.

unjustifiable to take the risk.⁶⁸ Knowledge would alternatively require the person to be aware that the circumstance existed or would exist.⁶⁹

Under the Criminal Code, paragraph 1041B(2)(b) would similarly require the offer to acquire or dispose of the financial products to be intentional. The circumstances of the offer relating to substantially the same number of financial products and at substantially the same price as a corresponding offer made or to be made by the person, or an associate (and known by the person), would also need to be established. The same fault elements of recklessness, knowledge or intention would apply as discussed in relation to paragraph 1041B(2)(a) above.

However, the effectiveness of subsection 1041B(2) is dependent upon the meaning of the opening phrase, namely '[f]or the purposes of subsection (1), a person is taken to have created a false or misleading appearance of active trading'. There is no doubt that this phrase means that physical element comprising the result of the conduct under subsection 1041B(1), namely the creation of a false or misleading appearance, is satisfied. On a literal reading of the provision, the conduct itself under subsection 1041B(1) would still need to be established. That is, it would still need to be shown under the opening words of subsection 1041B(1) that the person did, or omitted to do, an act intentionally.⁷⁰ However, this would not provide any additional burden on the prosecution as both paragraphs 1041B(2)(a) and (b) require proof of more specific conduct that would also need to be intentional and would satisfy the more general requirement in subsection 1041B(1).

The crucial question is whether the opening phrase in subsection 1041B(2) also means that the fault element attaching to the result of a false or misleading appearance under subsection 1041B(1) is satisfied. That is, it is not clear whether the deeming provision avoids the need to prove that the person intended, had knowledge of or was reckless in relation to the false or misleading appearance of active trading under subsection 1041B(1). Based upon a literal reading of the opening words of subsection 1041B(2), it is arguable that the deeming provisions only establish the physical element, namely the creation of the false or misleading appearance. Without any material in support of the alternative approach, the courts would likely construe this provision strictly given that it creates an offence.⁷¹ On this approach, the fault element attaching to the creation of the false or misleading appearance would need to be established separately as set out above.⁷²

The alternative argument is that it was intended that the satisfaction of the requirements in either paragraph 1041B(2)(a) or (b) would establish both the physical and fault elements attaching to the creating of a false or misleading appearance of active trading in subsection 1041B(1). This view is supported by the historical development of the provision. The corresponding deeming provisions in the 1980 Act and Corporations Law were accompanied by a defence that required the defendant to establish that their purpose(s) did not include the creation of a false or misleading

⁶⁸ Criminal Code, s 5.4(1).

⁶⁹ Criminal Code, s 5.3.

⁷⁰ See text following n 57 above.

⁷¹ See, for example, *Beckwith v R* (1976) 12 ALR 33 at 339 (per Gibbs J); *Krakouer v R* (1998) 155 ALR 586 at 600 (per McHugh J).

⁷² See above text accompanying n 58 and following.

appearance of active trading.⁷³ It was consequently concluded that, although the primary offence required intention or some other fault element, this was not necessary in relation to the deeming provisions in light of the defence.⁷⁴ Based upon this, it is arguable that it was intended that the deeming provisions would remove the need for the prosecution to establish that the defendant had such a purpose or intent. Otherwise, they would be of little use in the context of the difficulties in proving intent or an alternative mental element.

Although consistent with the reason why the deeming provisions were introduced, this alternative argument may be difficult to sustain given that the corresponding defence was not included in the FSR Act and the new provisions were drafted in the context of the Criminal Code.⁷⁵ There is also no discussion of the issue, and hence a lack of support for this view, in the voluminous explanatory material that accompanied the financial services reforms.⁷⁶ However, this is not unexpected given the difficulties in dealing with this level of detail in the context of a reform package involving the size and complexity of the FSR Act.

Proposals for reform

Treasury sought comments on a number of issues and a series of possible amendments to section 1041B in its March 2007 Discussion Paper on *Review of Sanctions in Corporate Law*.⁷⁷ As a preliminary issue, the Discussion Paper asked the question whether section 1041B should be amended to clarify the circumstances in which a person will be criminally liable due to the operation of subsection 1041B(2) and section 5.6 of the Criminal Code.⁷⁸ The above analysis under the heading ‘Deeming provisions in subsection 1041B(2)’ clearly demonstrates that the situation needs to be clarified. However, this leads to the more difficult questions concerning the changes that should be made. Interestingly, there was no clear support for any particular legislative approach in the submissions received by Treasury in relation to section 1041B.⁷⁹

Criminal liability

The first substantive issue arises from the uncertainty as to the application of the Criminal Code to subsection 1041B(2). That is, the question is whether criminal liability should apply where a person intended, was aware or was reckless, firstly, that trading without a change of beneficial ownership or matched trades would occur under subsection 1041B(2) or, secondly, that there would be a false or misleading appearance with respect to the matters in subsection 1041B(1).⁸⁰ The Discussion

⁷³ *Securities Industry Act 1980* (Cth) (1980 Act), s 124(4); Corporations Law, s 998(6).

⁷⁴ See above n 33 and accompanying text.

⁷⁵ See also above n 71 and accompanying text.

⁷⁶ There is only a brief explanation of the predecessor provisions to section 1041B: see Revised Explanatory Memorandum, Senate, Financial Services Reform Bill 2001 (Cth), p 176.

⁷⁷ Department of the Treasury, above n 19, p 42.

⁷⁸ *Ibid*, p 42.

⁷⁹ Consequently, section 1041B was not referred to in the Summary of Submissions released by Treasury in August 2007: see Department of the Treasury, *Review of Sanctions in Corporate Law Discussion Paper Summary of Submissions*, Commonwealth of Australia, 3 August 2007, <<http://www.treasury.gov.au/contentitem.asp?NavId=066&ContentID=1285>> accessed 17 December 2008.

⁸⁰ Department of the Treasury, above n 19, pp 39-40, 42.

Paper provides two scenarios that illustrate the difficulties in adopting the first approach without further amendment to the provision. Under these two scenarios, a person who sells and buys back a small parcel of shares in order to crystallise tax losses at the end of year or a person who conducts a ‘put through’ transaction on behalf of the same funds manager by a transfer of financial products from one nominee to another could be prosecuted for a criminal offence whether or not they intended, were aware or were reckless that there would be a false or misleading appearance.⁸¹

An alternative approach is suggested in the second substantive issue, under which criminal liability would apply without proof of intention, knowledge or recklessness. Instead, there would be a defence where it is proved that the person’s act did not include a purpose of creating a false or misleading appearance of active trading.⁸² The Discussion Paper highlights a number of difficulties with this approach, namely that it reintroduces the requirement of ‘purpose’ (which is uncertain, difficult to prove and contrary to Commonwealth criminal law policy), shifts the legal onus of proof to the defendant and also raises the prospect of a person avoiding liability where they know that their actions would mislead but where they have a different purpose.⁸³

These issues raise the crucial question whether it should be required that a person have an intention (or an alternative element of fault) relating to the creation of a false or misleading appearance concerning the market under section 1041B(1) where the elements of subsection 1041B(2) are satisfied. Given the effect of that a criminal record can have on a person’s reputation and livelihood,⁸⁴ it would not be appropriate for a person to be able to be convicted irrespective of any degree of fault. Consequently, it is appropriate that the fault elements in the Criminal Code apply to the prohibition in subsection 1041B(1) as a general rule.

However, the question remains whether the practices of ‘wash sales’ and ‘matched orders’ under subsection 1041B(2) are a special case due to the obvious harmful effects that they can have on other market participants. It has been observed that the United States courts have found ‘wash sales’ to be ‘manipulative in character’.⁸⁵ In addition to creating the appearance of more active trading than is actually the case, the ability for such trades to be placed to gradually increase or decrease in price can mislead other investors into believing that there is greater or lesser demand for the financial products than there in fact is. The perpetrator(s) can then enter into subsequent transactions allowing them to profit at the expense of unsuspecting investors.

The inclusion of the deeming provisions and accompanying defence in section 124 of the 1980 Act and section 998 of the Corporations Law provides support for the

⁸¹ Ibid, p 40.

⁸² Ibid, pp 40, 42.

⁸³ Ibid, p 41.

⁸⁴ For example, given that the offence is punishable by more than 12 months imprisonment, the person would be automatically disqualified from being a director for five years: *Corporations Act 2001* (Cth), s 206B(1)(b)(i), (2). A person who holds an Australian financial services licence could also be subject to a banning order: see ss 761A (‘financial services law’), 920A(1)(e); above n 47. An increase in the maximum penalty for an offence against section 1041B is also proposed in the text accompanying n 91 below.

⁸⁵ See above n 13.

contention that ‘wash sales’ and ‘matched orders’ should be treated differently to other forms of false trading and market rigging. Given the difficulties involved in establishing the mental element in relation to a false or misleading appearance and the clear distorting effects of transactions that do not involve a change in beneficial ownership or are otherwise matched through countervailing transactions, it is appropriate that the prosecution need only establish fault elements in relation to paragraph 1041B(2)(a) or (b) of the *Corporations Act*.⁸⁶ However, as demonstrated by the two scenarios discussed above,⁸⁷ it would be unfair to rely on prosecutorial discretion to avoid innocent market participants being caught by one of the deeming provisions. Accordingly, it would only be appropriate to remove the requirement to establish fault in relation to the false or misleading appearance of active trading if there was a defence that protects innocent parties.

In light of the difficulties identified in adopting a similar approach to that taken in the earlier legislation,⁸⁸ a new defence should be introduced which is better adapted to the circumstances. The insolvent trading provisions provide a useful template for this defence.⁸⁹ That is, it would be a defence to a prosecution under subsection 1041B(1) where the person had reasonable grounds to believe, and did believe, that the transaction under paragraph 1041B(2)(a) or offer under paragraph 1041B(2)(b) did not, or was not likely to, have the effect of creating, or causing the creation of, a false or misleading appearance of active trading in the financial products. The drafting of this defence would ameliorate the effects of the reversal of the onus of proof as it would allow the defendant to establish the circumstances in which it was reasonable for them to act as they did, rather than relying upon the proof of their purpose or intention. This places the onus on the defendant in relation to a matter that is peculiarly within their knowledge, is significantly more difficult and costly for the prosecution to disprove and provides that the defendant’s state of belief constitutes the excuse for their actions.⁹⁰

A further issue that was not raised in the Discussion Paper is the severity of the current penalties applicable to a criminal breach of subsection 1041B(1). As discussed above,⁹¹ compared to the possible civil penalty of \$200,000 for an individual and \$1 million for a body corporate, the corresponding maximum penalty of \$22,000 for individuals or \$110,000 for bodies corporate under Schedule 3 of the *Corporations Act* is clearly inadequate. The financial penalties attaching to the criminal offence should at least be on par with those available under the civil regime. As a result, it would be appropriate to increase the Schedule 3 financial penalty applying to subsection 1041B(1) to match that applicable to the insider trading provisions in section 1043A, which is currently \$220,000 for individuals and \$1.1 million for

⁸⁶ See above text following n 65. As discussed above, the application of the fault element of intention to an act or omission under subsection 1041B(1) does not place any additional burden upon the prosecution: see above text following n 70.

⁸⁷ See above text accompanying n 81.

⁸⁸ See above text accompanying n 83; *Securities Industry Act 1980* (Cth) (1980 Act), s 124(4); *Corporations Law*, s 998(6).

⁸⁹ See *Corporations Act 2001* (Cth), s 588H(3).

⁹⁰ Commonwealth Attorney-General’s Department, *Guide to Framing Commonwealth Offences, Civil Penalties and Enforcement Powers*, Interim New Edition – Uncleared Draft, December 2007, pp 29-31 <http://www.ag.gov.au/www/agd/agd.nsf/Page/Publications_GuidetoFramingCommonwealthOffences,CivilPenaltiesandEnforcementPowers> accessed 12 January 2009.

⁹¹ See above nn 48-49.

bodies corporate.⁹² It should also be considered whether the fine could be a proportion of the value of the transaction(s). This could be justified based upon the multiplier effect that such transactions can have on the market, with larger transactions having an increased distorting effect. It would also provide an increased deterrent for transactions in the order of those attempted in cases like *Nomura*.⁹³

Civil liability

The final substantive issue relates to the circumstances in which the civil penalty provisions in Part 9.4B should apply to contraventions of subsection 1041B(1). Comments were sought in the Discussion Paper on a number of possible approaches to this issue. The first two of these mirror the question raised in the first substantive issue discussed above, namely whether civil liability should be incurred if a person intended, was aware or was reckless, firstly, that trading without a change of beneficial ownership or matched trades would occur under subsection 1041B(2) or, secondly, that there would be a false or misleading appearance with respect to the matters in subsection 1041B(1).⁹⁴ Under the third approach, there would continue to be no need to prove a mental element. However, as suggested in the second substantive issue above, there would be a defence where it is proved that the person's act did not include a purpose of creating a false or misleading appearance of active trading.⁹⁵

Whether or not subsection 1041B(2) applies, it would not be appropriate to introduce any mental or fault element in determining whether there has been a civil contravention of subsection 1041B(1). This is consistent with both the current approach in relation to provisions attracting civil sanctions⁹⁶ and the proposed reforms in relation to the application of subsection 1041B(2) to the criminal offence discussed above. Indeed, it would be contrary to the purpose of the civil penalty provisions to introduce a mental element that would make a civil contravention as difficult to prove as in as a criminal offence. Instead, innocent parties (such as those contemplated in the two scenarios in the Discussion Paper⁹⁷), should be protected by the introduction of the same defence that is proposed for the criminal offence. That is, it would be a defence in a civil penalty proceeding for a contravention of subsection 1041B(1) where the person had reasonable grounds to believe, and did believe, that the transaction under paragraph 1041B(2)(a) or offer under paragraph 1041B(2)(b) did not, or was not likely to, have the effect of creating, or causing the creation of, a false or misleading appearance of active trading.

The final suggestion in the Discussion Paper of retaining the provision as it is, but giving the Court a discretion not to make a declaration of contravention under subsection 1317E(1) for a contravention of section 1041B(1),⁹⁸ would not be necessary. This is because concerns about the effect on innocent parties raised in the two scenarios in the Discussion Paper would be met by the introduction of the defence

⁹² *Corporations Act 2001* (Cth), ss 1311(1)-(1A), 1312, Schedule 3 items 311C, 312A; *Crimes Act 1914* (Cth), s 4AA.

⁹³ See above n 7 and accompanying text.

⁹⁴ Department of the Treasury, above n 19, 41-42.

⁹⁵ *Ibid.*

⁹⁶ See above n 47.

⁹⁷ See above n 81 and accompanying text.

⁹⁸ Department of the Treasury, above n 19, pp 41-42.

proposed above. Any amendment to introduce such a discretion into subsection 1317E(1) would need to be considered in relation to all of the civil penalty provisions rather than just for subsection 1041B(1). It is arguable that such an amendment is unnecessary given the ability of the court to relieve a person from liability under section 1317S. However, these issues would need to be weighed up in the context of the general operation of the civil penalty provisions in Part 9.4B.

Conclusion

Conduct manipulating financial markets poses a significant regulatory challenge, particularly in the context of the current uncertainty in global financial markets. The recent turmoil has demonstrated the impact that distortions in the market can have upon market confidence, economic outcomes and the community more generally. The prohibition against the creation of a false or misleading appearance relating to financial markets in subsection 1041B(1) of the *Corporations Act* is a central part of the arsenal against market misconduct in Australia. While the operation of subsection 1041B(1) is clear, there are difficulties with the framing of the deeming provisions in subsection 1041B(2). Importantly, it is uncertain whether the deeming provisions require the prosecution to establish a mental element in relation to the creation of a false or misleading appearance of active trading under section 1041B(1) where the elements of subsection 1041B(2) are satisfied.

Given the difficulties of establishing intention or an alternative element of fault in this area, the practices of ‘wash sales’ and ‘matched orders’ as circumscribed in subsection 1041B(2) should be treated in a special category. That is, transactions which involve no change in beneficial ownership or have countervailing transactions with substantially similar volumes and prices should be strictly proscribed due to their clear distorting effect on the market. Consequently, there should be no need to show intention, knowledge or recklessness in relation to the creation of a false or misleading appearance of active trading under subsection 1041B(1) where the requirements in subsection 1041B(2) are satisfied. This is consistent with the purpose for which the deeming provisions were introduced.

In order to ensure that innocent parties are not unfairly caught within the prohibition, a defence should be introduced based upon the insolvent trading provisions. That is, there should be a defence where the person had reasonable grounds to believe, and did believe, that the transaction or offer within the terms of subsection 1041B(2) did not, or was not likely to, have the effect of creating, or causing the creation of, a false or misleading appearance of active trading. This ensures that persons conducting transactions that are reasonably considered not to breach the prohibition will have a safe harbour. A similar defence should apply in relation to civil contraventions of the provision.

The relatively weak penalty attaching to a criminal contravention of subsection 1041B(1) is also a concern. At the least, the maximum penalty should match that available under the civil penalty provisions and would ideally be the same as that applicable for an insider trading conviction. Consideration should also be given to allowing the penalty to be a proportion of the transaction(s) involved to take into account the distorting effect on the market.

These matters need to be addressed as a matter of urgency to ensure that the law is both observed and can be enforced effectively. Otherwise, the policy objective of section 1041B will continue to be undermined as it currently provides too frail a shield against manipulative conduct. Further work also needs to be done in relation to the other market misconduct provisions in Part 7.10 Division 2 of the *Corporations Act*. The Companies and Markets Advisory Committee is currently examining whether changes need to be made in relation to the provisions dealing with the spreading of rumours affecting the market.⁹⁹ Consideration should also be given to whether it would be possible to remove overlap between the market misconduct provisions and so remove unnecessary complexity. However, resolving the deficiencies in section 1041B as proposed in this paper would be a good place to start.

⁹⁹ See above nn 2-3 and accompanying text.