SAMPLE ANSWER
2008 EXAM PART B

[Note: This is a complete and detailed answer that identifies all of the issues I intended to raise in the problem question in the 2008 exam paper. I would not have expected any student to have spotted all of these issues or to have written as detailed an answer as this under the constraints of exam conditions (if they did, they would have received a mark of 100% for the paper).

You do NOT have to follow this style in answering the problem question in the exam. The point of the problem question is for you to demonstrate that you can spot the compliance issues and express them in a way that shows that you understand them. You can do that in whatever style suits you.

You may not necessarily agree with all of the conclusions expressed in the sample answer below (for example on what is and is not inside information). Again, the point of the problem question is for you to demonstrate that you can spot the compliance issues and express them in a way that shows that you understand them. You won't be penalised for reaching a different conclusion on any particular issue if your position is reasonably argued.

Please also note that since the 2008 exam, the provisions of the Corporations Act regulating short selling have been substantially amended and the ASX Market Rules have been repealed and replaced by the ASIC Market Integrity Rules (ASX Market) 2010 and the ASX Operating Rules. A different answer to this question would therefore be required today to that written in 2008.]

The facts presented raise the following legal and regulatory compliance issues:

Chinese walls

A conglomerate financial services company needs to have reasonable and effective "Chinese wall" arrangements in place to prevent insider trading, protect confidential information and manage conflicts of interest. Reasonable arrangements do not require perfection (the *Citigroup case*) but they should include physical separation to insulate relevant departments from each other, strict and carefully defined procedures for wall crossings, and monitoring by Compliance officers of the effectiveness of the wall (*Bolkiah v KPMG*).

There are some obvious issues about the Chinese wall arrangements maintained by Pitibank.

The first relates to the weekly meetings of the senior executive group attended by, amongst others, the head of the corporate advisory group and the head of stockbroking. Management meetings between senior executives on opposite sides of the Chinese wall need to be carefully controlled to ensure that they do not lead to the accidental leakage of inside information. For those meetings to be discussing "workloads" in the corporate advisory group and mentioning confidential corporate advisory mandates in that context is entirely inappropriate and in flagrant disregard of proper Chinese wall protocols.

The second relates to the conversation that took place between Ferrari and Ino. The difference between what Ino told Ferrari he was planning to publish in his research on FFL and what he actually published would seem to indicate that Ferrari may have said more to Ino than just that FFL was a major client of the firm. Ino modified his research to remove the statement that "FFL is likely heading for receivership unless it can find a white knight who can inject significant capital into the business and reduce its gearing" and to include statements that FFL was "significantly undervalued" and "an attractive candidate for a takeover". This suggests that there is some substance in the comment that Ino subsequently made to Smart that he had been asked to "sugar coat" his research. In fact, it looks to me that he may have been asked (or perhaps even directed) to present his research in a way that would encourage readers to think that FFL was worth more than its current market price. Again this indicates a significant lack of awareness on the part of Ferrari (and also Ino) of proper Chinese walls protocols.

[As an aside, I note that the conversation in this case bears some resemblance to the conversation mentioned in the *R v Hannes* appeal, where a senior corporate adviser who was working on a defence mandate for TNT spoke to an analyst and influenced what was said about TNT's takeover prospects in his research.]

The third relates to the conversation that took place between Darules and Smart. That conversation is not dissimilar to the "cigarette on the pavement" conversation that took place between the house trader (Manchee) and his boss (Darwell) in the *Citigroup case*. In the *Citigroup case*, the court held that the conversation in question did not result in Citigroup's Chinese wall arrangements being inadequate. However, there are aspects of that ruling that are not entirely satisfactory. In this case, Darules should not have taken matters into his own hands when he became concerned about Smart's trading. He should have first consulted the Compliance department to determine if there were any insider trading/Chinese wall ramifications in having that conversation. If he had, there would no doubt have been some consideration given to formally bringing Smart "over the wall" in relation to FFL via a properly documented wall crossing.

Finally, it is generally accepted that the minimum requirements for proper Chinese walls include a compliance review of proprietary trading against both watch lists and restricted lists (see NYSE/NASD Info Memo 91-22). In this case, I would have expected FFL to be on Pitibank's watch list and Smart's trading in FFL shares to have been monitored by Compliance. No such monitoring is mentioned in the facts presented and that is a cause for concern.

Insider trading

The fact that Smart executed a buy order for 2% of the issued shares in FFL at $1.50 per share shortly before the close of trading, and a takeover was announced after the close of trading at $2.25 per share, is something that is likely to attract a "please explain" from ASX Market Supervision.[1] It raises a suspicion of insider trading.

In this regard, there are four pieces of information that warrant consideration as to whether they are "inside information" and therefore might have caused Smart's trading in FFL shares to have breached the insider trading prohibition in section 1043A:

(1) the fact that FFL had given Pitibank a defence mandate because of its concern that it might be the target of an opportunistic takeover bid;

(2) the comments made by Darules to Smart in the conversation on the pavement that "something's up" and that "us buying stock at this point doesn't look good";

(3) the comments made by Ino to Smart that he had been asked to "sugar coat" his research and that if FFL "was a horse, it would glued not Viewed"; and

(4) the launch of the Bad Frock and Gown ("BFG") takeover bid.

The first is probably not inside information. The fact that a company whose share price has performed very poorly might be concerned about being taken over is hardly surprising and is not likely to influence professional investors in deciding whether or not to acquire or dispose of FFL shares (section 1042D), at least in the absence of some speculation that an actual takeover bid is in the offing. Even if it was inside information, that fact was not mentioned in the conversation that took place between Darules and Smart on the pavement and there is nothing to suggest that Smart was aware of the defence mandate when he traded in FFL shares.

[1] Since the 2008 exam was written, ASIC has taken over responsibility for market supervision from ASX (this occurred on 1 August 2010). These days, the "please explain" would come from the market surveillance team at ASIC rather than ASX Market Supervision.

The second is also probably not inside information. Darules' comments of themselves do not indicate anything positive or negative about the value of FFL shares. In this regard, the information is qualitatively similar to the "cigarette on the pavement" conversation that took place between the house trader (Manchee) and his boss (Darwell) in the *Citigroup case*, which was held not to be inside information.

The position in relation to the third is less clear but I lean to the view that again it is probably not inside information. While it would certainly suggest that Ino had a more negative view about FFL than was presented in his research, against a backdrop where FFL's share price has dropped from $50 to $2 in under 2 years and its financial problems would therefore appear to be well understood by the market, it seems doubtful that this information in and of itself would influence professional investors in deciding whether or not to acquire or dispose of FFL shares.

The fourth was clearly inside information before it was publicly announced. However, there is nothing to suggest that Smart was aware of the BFG takeover bid when he traded in FFL shares. His last buy order near the close simply reversed the short sale he had effected earlier in the day. Smart had no FFL shares after he completed that trade and therefore he could not have profited from the BFG takeover bid. If he had been aware of the BFG takeover bid, you would have expected him to ensure that he had some FFL shares left that he could have sold into the bid at a profit.

Market manipulation

The fact that Smart's selling pushed the price of FFL's shares from $3.00 down to $1.50 immediately prior to a takeover bid being launched at $2.25 is something that again is likely to attract a "please explain" from ASX Market Supervision.[2] It raises a suspicion of market manipulation.

Whether or not there is market manipulation is by no means clear. Smart's trading in the early part of the day was driven by his desire to build a position where he could profit from a potential takeover of FFL. His trading in the latter part of the day was driven by a desire to exit that position without making a loss. Depending on how you allocate the profit from his trading, he seems to have achieved that aim. It could therefore be argued that the price movements in FFL shares on the day simply reflected the "forces of genuine supply and demand" (per Mason J in *North v Marra Developments Ltd*).

However, if it could be shown that Smart had deliberately set about selling his 7% parcel (the 5% he bought and the 2% he borrowed) in such a way as to artificially depress the FFL share price so that he could then profit when he bought back his 2% short position, then he would potentially have a case to answer for market manipulation.

Research independence

The comment by Ino to Smart that he was asked to "sugar coat" his research on FFL is troubling. It indicates that he feels that his published research on FFL no longer truly reflects his views on FFL. The removal of the reference that "FFL is likely heading for receivership unless it can find a white knight who can inject significant capital into the business and reduce its gearing" and its replacement with a reference to FFL being "significantly undervalued" and "an attractive candidate for a takeover bid" is clearly a material change to his research and, if Ino does not genuinely hold that view, is potentially misleading.

By changing his research to conceal his true opinions about FFL, Ino potentially breached section 1041H of the Corporations Act and section 12DA of the ASIC Act (misleading and deceptive conduct in the provision of financial services) and perhaps even section 1041F of the Corporations Act (inducing someone to deal on the basis of misleading statements).This would

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[2] See note 1 above.

particularly be the case if Ino had altered his investment recommendation, for example, from a "sell" to a "hold" or "buy" (something on which the facts presented are silent).

[As an aside, I note that Ino's original comment in his research that FFL was a "dog" and his subsequent comment to Smart that FFL would be "glued not Viewed" if it were a horse are not dissimilar to the types of comments that Merrill Lynch analysts were found to have made about internet stocks in the Spitzer investigation into the conduct of Wall Street research analysts in 2002-3. That investigation found that research analysts from a number of prominent firms had misled investors by publishing unduly rosy research about various stocks that was designed to win favour with investment banking clients and did not reflect their true opinion. The firms involved were ordered to pay close to US$1.5 billion in compensation.]

The SIA/SDIA Best Practice Guidelines for Research Integrity, which ASX participants are expected to follow (see ASX Market Rules 3.6.3 and 4.1.1[3]), recognise that firms offering research need to have in place well-defined Chinese walls and other appropriate compliance procedures to prevent the dissemination of information which may compromise the integrity of research or investment recommendations.

Ordinarily those arrangements would be run by a central Compliance department that sits above the Chinese wall and is independent of, but has visibility into, the equities research area and the corporate advisory area. That department would have the power and the responsibility to stop research being published on sensitive stocks, such as FFL in this case.

It was entirely inappropriate that Ferrari directly pressured Ino to change the contents of his research on FFL, even if he had valid concerns about the potential impact of Ino's disparaging comments on the client relationship with FFL. The proper course for Ferrari to follow if he had such concerns was to refer the matter to the central Compliance group responsible for vetting research and for them to consider his concerns and take the appropriate action.

More generally, for Ino to be considering publishing research that described FFL as a "dog" and its management as having "lost the plot" is not the sort of commentary you would expect from a reputable and professional financial services organisation. Pitibank should also have a process in place for vetting research for quality assurance and to ensure that it does not contain unduly disparaging or defamatory comments.

Managing conflicts

Under section 912A(1)(aa) of the Corporations Act, Pitibank is required to have in place adequate arrangements for the management of conflicts of interest that may arise wholly or partially in its financial services business.

In this case, it could be argued that there is a "commercial conflict" in Smart's trading activities, which ultimately led to FFL's share price falling because of his aggressive selling, when Pitibank had instructions to assist FFL in a takeover defence and FFL's commercial interests were to ensure that its share price stayed as high as possible. The fact that Darules acted to stop Smart's proprietary trading would certainly suggest that he thought it was inappropriate in the circumstances (although that happened when Smart was buying rather than selling).

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[3] ASX Market Rule 3.6.3 used to require an applicant for admission as a market participant to have appropriate supervisory policies and procedures, and meet any standards or requirements set out or referred to in the ASX Market Rule Procedures, to ensure compliance by the applicant and each person involved in its business as a market participant with the ASX Market Rules and the Corporations Act. The SIA/SDIA Best Practice Guidelines for Research Integrity was one of the prescribed standards in the Procedures.

ASX Market Rule 4.1.1 required a market participant to continue to satisfy the admission requirements.

ASX Market Rule 3.6.3 has no counterpart in the ASIC Market Integrity Rules (ASX Market) 2010 or the ASX Operating Rules.

In the *Citigroup case*, the court held that the converse activity – the proprietary desk of Citigroup aggressively buying stock in Patricks and causing its share price to rise when it had instructions from Toll to advise on a bid for Patricks – was not a "conflict of interest" for the purposes of section 912A(1)(aa), even though Sinclair (the head of stockbroking) and Darwell (the head of the proprietary trading desk) clearly thought it was as they tried to stop it. If that holding is correct (and there is some dispute as to whether it is), then it would also apply in this case.

In addition, in the *Citigroup case*, the court held that the alleged conflict did not arise wholly or partially in Citigroup's financial services business, since advising on a takeover is not a financial service (regulation 7.1.29(3)(c)) and nor is dealing in securities on your own account (section 766C(3)). Again, if that holding is correct (and it probably is), then it would also apply in this case.

A conglomerate financial services company that provides advisory services and also trades on proprietary account is likely to face these types of "commercial conflicts" all the time. Regardless of whether section 912A(1)(aa) applies, those types of conflicts would ordinarily be "managed" by a firm such as Pitibank including in its corporate advisory mandates:

(a) a statement that Pitibank carries on a range of businesses, including stockbroking and sales and trading activities on its own account, and that it is possible that its various divisions might hold FFL shares and effect transactions in FFL shares for their own account or for the account of their clients;

(b) a statement that there are Chinese walls between the corporate advisory area and other areas of the Bank that may be trading in FFL shares; and

(c) an acknowledgement by the client that this is an appropriate mechanism for managing any potential conflict or interest,

as well as ensuring that the Chinese wall between the corporate advisory area and the trading desk is strictly observed.

I would want to check the engagement letter that Pitibank sent to FFL for the defence mandate to see if it contained such a provision. If it did, that would be helpful on the conflicts issue, but the observations above about the deficiencies in Pitibank's Chinese wall arrangements would have even greater force. Those deficiencies would weaken Pitibank's ability to rely on such a provision in its mandate letter.

Short selling

Smart borrowed FFL shares to facilitate his selling activities on the afternoon in question. Given the short time between his discussion with the stock lending desk and his selling, I strongly suspect that the shares in question would not have been legally transferred to Pitibank at the time of the sales and, accordingly, that Pitibank would not have had a presently exercisable and unconditional right to vest them in the buyer. Smart would therefore have been relying on Pitibank's ability to borrow the shares in due course to complete his sales without infringing the short selling rules in section 1020B.

In these circumstances, Smart would need to have satisfied the requirements of section 1020B(4)(d)[4] in order to legally short sell the FFL shares. Amongst other things, Pitibank would need to have entered into a formal share borrowing agreement before Smart commenced his sales (section 1020B(4)(d)(ii)) and Smart would need to have ensured that each of his sales only took place on the "uptick" (s1020B(4)(d(iii))).

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[4] Note that section 1020B(4)(d) was repealed in 2009. A different answer would be required in relation to this issue under the current law.

It is unclear on the facts presented whether Smart/Pitibank in fact complied with the first requirement.

The practical difficulties of complying with the second requirement are abundantly clear in this case. Smart in fact sold 7% of the shares in FFL – the 5% he had purchased and the 2% he had borrowed. How do you determine out of the 7% he sold which 2% had to meet the uptick requirement? Suffice to say, it seems highly unlikely that Smart in fact met the second requirement. The first 2% he sold at $3 when FFL's share price was flat. The remaining 5% he sold into a falling market.

Substantial shareholder notice

I note that Smart purchased 5% of the issued shares in FFL and borrowed a further 2%. At one point in time, therefore, Pitibank would have had a "relevant interest" in at least 7% of the issued voting shares in FFL.

Having acquired a 7% parcel, Pitibank would have been required to lodge with FFL and the ASX within 2 business days of the acquisition:

(d) if Pitibank was not a substantial shareholder in FFL at the time of the acquisition, a notice of substantial shareholding (5%+); or

(e) if Pitibank was already a substantial shareholder in FFL at the time of the acquisition, a notice of change of substantial shareholding (±1%).

This applies even though Smart/Pitibank sold all 7% of the FFL shares on the same day that they were acquired.

In addition, having disposed of that 7% parcel, Pitibank would have been required to lodge with FFL and the ASX within 2 business days:

(f) if Pitibank ceased to be a substantial shareholder in FFL as a result of the disposal, a notice of cessation of substantial shareholding (<5%); or

(g) if Pitibank continued to be a substantial shareholder in FFL after the disposal, a notice of change of substantial shareholding (±1%).

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