CASE NOTE

SECURITIES COMMISSION V R E JONES[1]

1. The Securities Amendment Act 1988 Part II: disclosure of interests

The Securities Amendment Act 1988 ("the Act") has been in force since 21 December 1988. When it was first introduced into Parliament in July 1988 nearly all the attention was focused upon Part I of the Act which introduced the insider trading provisions and there was little comment on the provisions in Part II of the Act which dealt with the disclosure of interests of substantial security holders.[2] However, in terms of litigation there have been more actions under Part II than under Part I.[3]

Part II is aimed at ensuring that the market (via the public issuer and the stock exchange) is informed as to "the identity of persons who are entitled to exercise, or control the exercise of, significant voting rights in a public company".[4] The Act sets out to provide a framework for the provision of this information by placing an obligation of disclosure upon substantial security holders. Section 21 of the Act requires a substantial security holder to notify the public issuer and the stock exchange of any change in its holding that is equal to 1% or more of the total number of issued voting securities of the public issuer.

The Act goes further than merely requiring a substantial security holder to disclose its shareholding. Section 28 gives a public issuer (either at its own motion or at the request of members who hold at least 5% of the public issuer's voting securities) the power to require disclosure by a substantial security holder as to who holds relevant interests in the voting securities held by the substantial security holder. Section 29 is an even more extensive power since it allows the public issuer to request "any person who the public issuer believes has, or may have, a relevant interest in voting securities of the public issuer" to supply "such information as [the public issuer] may

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1 (1993) 6 NZCLC 68, 547

2 NZPD Vol 490, 1988: 5280-5284.

3 The few cases involving Part I of the Act have been limited to procedural questions, and in particular who has the right to control an action against an alleged insider. A simple explanation for the difference in the number of actions is that under Part II the Securities Commission may make an application for orders (s 31(a)) whereas under Part I it does not have standing. In a discussion paper issued by the Securities Commission in 1992, the Commission raised the question whether it should also have standing under Part I (*Proposed Practice Note on Insider Trading - A Discussion Paper* (1992) 25).

4 Supra note 2, at 5283.

specify" for the purpose of assisting the public issuer to ascertain who is, or may be, a substantial security holder.

The legislative muscle provided as a backup to these provisions is set out in sections 30 to 32. Under section 30 the court has jurisdiction to grant an order under section 32 where it has "reasonable grounds to suspect" that a substantial security holder has not complied with Part II.[5] The orders the court can make under s.32(1) include directions requiring compliance with Part II, prohibiting the exercise of voting rights, suspending registration of transfers of shares, or ordering the forfeiture of any voting securities of the public issuer.

In introducing the first reading of the Securities Law Reform Bill, the Minister of Justice made the following remarks:

> I do not propose to deal in detail with the provisions of [Part II], as they are mainly procedural, but I do need to comment on clauses 30 to 32, and clause 34. Clauses 30 to 32 provide sanctions for breaches of the disclosure requirements. In accordance with the [Securities Commission's] report on nominee shareholding, those clauses provide civil sanctions against the voting securities themselves, ranging from court orders prohibiting the exercise of voting rights to, in extreme cases of non-compliance, orders forfeiting the voting securities – the most serious sanction.[6]

There was no further discussion of these provisions during the course of the debate on this piece of legislation. No one took up the issue as to whether or not the low standard of "reasonable grounds to suspect" was appropriate for all the orders that could be made under section 32. The remedies provided for under section 32 vary enormously in their potential impact upon a transgressor of Part II. For example, an order for the forfeiture of voting securities is a serious sanction which one would imagine should be exercised more cautiously than the granting of an order temporarily restraining the exercise of voting rights. However, the commencing words of section 32 merely provide that the Court may make any of the listed orders on an application under section 30 of the Act.

2. Case-law prior to Securities Commission v R E Jones

In *Brook Investments Ltd v Palladin Ltd*, Sinclair J dealt with one of the first cases under Part II.[7] In this case a company, incorporated in Bermuda, carrying on business in Hong Kong and listed on the Hong Kong and New Zealand Stock Exchanges, sought to utilise section 29 of the Act to

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5 The court also has jurisdiction under s 32 where a person has not complied with a request under ss 28 or 29 of the Act (see s 32(b)).

6 Supra note 2, at 5283.

7 Unreported, High Court, Auckland, 21 October 1989, M 1581/89.

determine who was holding the relevant interests in its voting securities which had been acquired overseas. The company was to hold its annual general meeting in Hong Kong on 23 October 1989 and there was concern that there could be a change in control of the company at that meeting. The replies to the notices issued by the company were considered to be inadequate. Accordingly an application was made for orders under section 32 by a member of the company, with the company served as a defendant.[8] In effect this case concerned an attempt by the public issuer and one of its members to "flush out" those overseas persons who appeared to be intent upon taking over the control of the company (and possibly stripping the company which had $4 million in assets in New Zealand).

Sinclair J described the purpose of Part II as being designed to:

> ensure that a public issuer, its members, the Stock Exchange and the investing public at large are kept informed as to the ownership of voting securities in a public issuer and as to the identity of those who are, or may be, in a position to control the company. In particular it is aimed at restricting secret dealings in shares for a takeover advantage.[9]

Sinclair J gave orders which prohibited the registration of the transfer or transmission of shares held by particular overseas interests and suspended the voting rights of these shares until at least after the annual general meeting.[10]

Sinclair J's decision showed that the Court was prepared to use its new powers in relation to the suspension of registration and voting powers where it considered the fulfilment of a substantial security holder's obligations under the Act had not been met. However, as the orders sought were in effect temporary restraining orders, Sinclair J did not enter into any discussion of the threshold question as to what was needed to grant him jurisdiction under section 32. No application was made for a forfeiture of the voting securities which were at the centre of this dispute.

Another major decision under Part II was *Securities Commission v. Honor Friend Investment Ltd.*[11] This case, like *Paladin*, involved the purchase of shares in a company by overseas interests as well as by New Zealand interests. A complicated funding and share purchase arrangement was put in place with the ultimate aim of using the funds of Euro-National Ltd ("ENC"), a publicly-listed company, to support the purchase of its own

8 Sinclair J noted that the plaintiff and defendant in this case were in fact openly acting in concert in bringing the application before the court (at 5).
9 Ibid, 18.
10 Ibid, 4-5.
11 (1991) 5 NZCLC 67,512.

shares in breach of section 62 of the Companies Act 1955. The purchasers of the shares failed to comply with Part II of the Act. A major difference between this case and the *Paladin* decision was that the applicant in this case was the Securities Commission which was applying for a forfeiture of half of the shares in issue (which would have amounted to a penalty of around $9 million).[12]

Heron J discussed section 30 of the Act, which gives the court jurisdiction to make orders under section 32 where there "are reasonable grounds to suspect" non-compliance with Part II. Heron J pointed out that this established a lower than normal standard of proof in relation to the existence of a substantial security holder and the failure to comply with Part II.[13] In this context, Heron J discussed McGechan J's decision in *Securities Commission v Gulf Resources and Chemical Corporation.*[14] Here, McGechan J had been troubled as to how to apply this standard in relation to an application for forfeiture of voting securities. McGechan J commented:

> Whatever the case, at least in theory, a Court which has reasonable grounds to suspect non-compliance could make orders ranging up to the extremity of forfeiture of shares as sought in the application filed in this case. While it is conceivable, I suppose, that the legislature intended such an extreme solution, the mind rather rebels (at least outside wartime conditions) against a confiscation and redistribution based merely upon a suspicion, even where the suspicion is based upon reasonable grounds.[15]

McGechan J decided to accept the approach to the issue proposed by the Securities Commission. This was that, once reasonable grounds to suspect were found, it was up to the defendant to satisfy the Court that "no reasonable gounds for suspicion any longer existed".[16] However, McGechan J stated that, even if this was the test, which he was prepared to accept for the purposes of that case, the court still retained a discretion as to what remedial orders it should make. In the end he found that, on the evidence, there were no reasonable grounds to suspect that there had been a failure to comply with the Part II.[17] Accordingly, this meant that he was saved from having to consider whether the test of "reasonable grounds for suspicion" was sufficient to justify an order for the forfeiture of the voting securities in question.

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12 Ibid, 67,533.
13 Ibid, 67,517.
14 (1990) 5 NZCLC 66,324.
15 Ibid, 66,630.
16 Ibid, 66,331.
17 Ibid, 66,334-66,335.

In the *Honor Friend* case, Heron J dealt with the issue of what was a sufficient ground for granting an application for forfeiture of voting securities. He took the view that in determining the primary facts that would *lead* to a reasonable suspicion he would apply the "normal civil standard".[18] His dislike for basing remedies upon "a reasonable suspicion" showed when he stated:

> I also had regard to the fact that in arriving at a conclusion of reasonable suspicion I might then be required to impose a penalty as drastic as forfeiture *which could not justify the wholesale rejection of conventional methods of proof or the proper standard of proof on all but the issue of relevant interest.*[19]

Heron J went on to say that provided the background and aggravating circumstances were proved to the normal civil standard then "I see no further restraint on the discretion to exercise all the powers given by section 32".[20]

In the end Heron J found that the evidence of the holders of the relevant interests "met the normal civil standard".[21] Consequently, he was required to consider the relief that should be granted. The Securities Commission had sought forfeiture of one half of the relevant shares but Heron J was only prepared to grant a forfeiture for 20% of the relevant shares (which amounted to a loss of $1.8 million).[22] He also ordered that the voting rights of Honor Friend Ltd were only available for a number of voting securities that were one less than the shares held by Impala Ltd (the other significant minority shareholder holding 25% of the issued share capital) and that the balance of the shares did not have voting rights.[23]

In determining the penalty to be imposed Heron J decided that an attempt to compensate shareholders should be made and that an order for forfeiture of some of the shares would achieve this goal.[24] However, apart from noting that "non disclosures in this case largely flow[ed] from the desire to use the company's cash resources in an improper fashion",[25] and "the case calls for relief which reflects the breach of both the letter and the spirit of the securities legislation and the near successful raid on a substantial part of ENC's undertaking",[26] the only reason offered by Heron J for the imposition

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18 Supra note 11, at 67,517.
19 Idem (emphasis added).
20 Ibid, 67,518.
21 Ibid, 67,519.
22 Ibid, 67,534.
23 Idem.
24 Ibid, 67,533.
25 Idem.
26 Idem.

of the forfeiture remedy was that "[the] company and its shareholders have incurred expenditure and been distracted from their proposed course by decisions made by interests as represented now by Honor Friend Ltd and the value of the company has declined accordingly".[27] No reasons were put forward for the quantity of shares forfeited.

The other issue that had been considered in the *Gulf* and the *Honor Friend* cases was that of costs. Unlike the *Paladin* case, these cases involved the Securities Commission as the applicant. In the *Gulf* decision, the Securities Commission was unsuccessful in its attempt to show that Gulf had a relevant interest that should have been disclosed. McGechan J did not accept criticisms by Gulf that the Securities Commission should not have brought the action and in fact went so far as to say that the Securities Commission had "acted entirely properly in placing this matter before the Court and would have failed in its statutory duties if it had not done so".[28] However, having dismissed the proceedings, he stated: "Costs are reserved. Memoranda may be submitted if desired. I do not encourage application by any party."[29] In effect, he was rewarding the Securities Commission for its actions by refusing to make the normal order for costs to the successful party. The low threshold ("reasonable grounds to suspect") required under section 30 justified the Securities Commission's action.

In the *Honor Friend* decision, Heron J noted that the proceedings had "been costly of time and effort for the Commission and it [had] been convincingly successful".[30] However, he did not see that he had a "mandate for elevating the [Securities Commission] to a position above that of other litigants in this commercial area."[31] While he was prepared to order substantial party and party costs he was not prepared to grant solicitor and client costs. Accordingly, Heron J's approach stands in contrast to McGechan J's approach in the *Gulf* decision where McGechan was prepared to depart from the usual rule in relation to costs in the light of the Securities Commission's "statutory duty".

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27 Idem.

28 Supra note 14, at 66,336. It is interesting that McGechan J found that the Securities Commission had a positive duty to bring the application. Section 31 provides that a number of persons may bring the action, including the Commission, the public issuer, or a holder of securities in the public issuer. The terms of section 31 are not expressed in such a way as to lead one to the necessary conclusion that the Commission has a positive duty to bring actions. McGechan J's statement could be put in the category of statements made to justify a departure from the costs rule rather than a strict interpretation of section 31.

29 Idem.

30 Supra note 11, at 67,534.

31 Idem.

3. McGechan J's Judgment in Securities Commission v R E Jones

McGechan J had the opportunity to consider further the provisions of Part II when he heard one of the most highly publicised corporate trials in recent years. The Securities Commission applied for the forfeiture of 40 million shares held by Sir Robert Jones and his interests in Robt Jones Investments Ltd ("RJI"). A significant difference between this case and the previous cases is that this was the first to deal with the non-disclosure of the *sale* of voting securities in a public issue, rather than the non-disclosure of the *purchase* of voting securities. A further difference is that there was little or no dispute as to who held relevant interests in the voting securities and as to when they were sold.[32] As McGechan J pointed out in his judgment his role was to consider "a claim arising from [the] *failure to file certain statutory notices*" and it was not to consider the "general commercial morality" of RJI.[33] In essence the decision was about the quantum of the penalty to be imposed, rather than whether or not there had been a transgression of Part II of the Act.

The claim in this case was based on the failure to file some eleven notices required under section 21 of the Act.[34] McGechan J described the Securities Commission's claim in this case as "one of [a] secret selldown by Sir Robert's interests, and within that certain other unacceptable commercial activity, both facilitated by absence of s 21 1% notices".[35] The Securities Commission claimed that there was a deliberate decision on the part of Sir Robert Jones and other executives of the companies involved not to file the notices required under Part II in order to facilitate a number of transactions for the benefit of Sir Robert Jones, and (in some instances) RJI.[36] McGechan J found that Sir Robert Jones was not aware of the "1% rule", although other executives involved in RJI clearly were.[37] McGechan J was even prepared to go so far as to say that had Sir Robert been aware of the rule "he would have given notice in respect of all transactions now impugned".[38] However, he found that the omission to file the required notices was deliberate on the part of some of the executives of RJI.[39]

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32 Supra note 1, at 68,550.
33 Ibid, 68,551 (emphasis in the original).
34 Idem.
35 Ibid, 68,549.
36 Ibid, 68,550. The transactions identified were the sale of 85 The Terrace, Wellington in order to inflate RJI's 1990 annual profit; sales of shares by Robert Jones Holdings Ltd to, and through, Carad Holdings Ltd; and a stand in the market by Sir Robert Jones (with the shares being bought by Carad Holdings Ltd).
37 Ibid, 68,552 to 68,553.
38 Ibid, 68,553.
39 Idem.

McGechan J discussed the issue of the standard of proof required under Part II. He noted that all that was required to establish "the essential ingredients of 1% shift and absence of notice" was a reasonable ground to suspect.[40] However, there was no indication as to "'how well' associated aggravating or mitigating factors, going beyond essential ingredients, should be proved".[41] While Heron J had taken the approach in the *Honor Friend* decision of requiring the normal civil standard in relation to these elements, McGechan J decided that the correct approach was to allow proof of both aggravating and mitigating circumstances on the lower standard of "reasonable grounds to suspect" since this approach recognised the difficulties of proof faced by the Securities Commission in this area.[42] For McGechan J the dangers inherent in relying upon such lower standards were to be controlled by the Court's discretion in granting a remedy. In his view, where the Securities Commission was only able to rely upon "reasonable grounds to suspect", "a Court will be so much slower, and in appropriate cases quite unwilling, to act in any draconian fashion as by forfeiture".[43] While he had earlier commented that Parliament did not appear to have turned its attention to a question of the standard of proof in relation to mitigating and aggravating circumstances, McGechan J went on to find that Parliament would have been content to leave the Court to determine the appropriate remedies "in an expectation Courts would act cautiously and sensibly, given lower-grade proof along with all other circumstances."[44] In any event he stated that he had considered all the significant matters at "the higher level of balance of probability."[45]

Having discussed what was the standard required under Part II, and having discussed his findings on the facts, McGechan J considered the question of relief. In terms of general principles he noted that the legislature had opted not to provide for criminal sanctions but rather to rely upon civil relief.[46] In his view Part II provided not only a compensatory regime since the civil sanctions "could be severe in the extreme" and the legislature clearly envisaged some transgressions that warranted "strong and punitive responses".[47] Coupled with these aspects of relief was the issue of deterrence. As McGechan J noted, the provision of information which was

40 Ibid, 68,550.
41 Idem.
42 Ibid, 68,551.
43 Idem.
44 Idem.
45 Idem.
46 Ibid, 68,584.
47 Ibid, 68,585.

late could serve little purpose. Consequently it was important to prevent an impression that compliance with Part II was not necessary.[48]

Having set out the underlying principles of the relief available under Part II McGechan J attempted to balance the various principles. While relief could be compensatory it appeared preferable in his view that:

> a truly compensatory approach be ... left for individual proceedings by those injured eg for insider trading, where losses can be more precisely measured and allocated. There should be no blind principle that remedy (sic) is to be governed by amount of loss, or gain, or the resources of the defendant.[49]

In relation to the punitive and deterrent elements he was concerned that the remedy should be a measured one and that the circumstances such as "knowledge and ignorance; defiance and oversight; major and minor share volumes; frequent and rare occurrence; significant and minor consequences" should be borne in mind.[50] McGechan J also pointed out sections 6 and 21 of the New Zealand Bill of Rights Act 1990 as being relevant elements "pointing to construction against 'unreasonable' seizure of property".[51]

In applying these general principles to the facts before him he emphasised that it should be clearly signalled to the market that Part II had to be strictly observed. In his view, the signal to be sent was through the damage done to personal and corporate reputation if notice was not given and by financial penalties.[52] As this particular trial was so well publicised the first had been met. In relation to the second McGechan set out those features which pointed towards moderation and those which pointed towards rigour.

In his view moderation was called for as Sir Robert had been ignorant of the requirements of the "1% rule", the persons who knew of the rule had failed to understand the seriousness of non-compliance, and, although the property transaction with 85 The Terrace caused increased losses to RJI and to some shareholders, Sir Robert was not the cause of the end of the property market boom nor the corresponding decline in RJI's price.[53] In addition, Sir Robert had himself lost millions in the general decline. On the other hand, there had been a deliberate decision by executives administering his interests not to file notices, and a number of the transactions were facilitated by non-compliance with Part II (which in his view was of particular concern).[54]

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48 Idem.
49 Idem.
50 Idem.
51 Idem.
52 Idem.
53 Ibid, 68,586.
54 Idem.

Having considered these factors McGechan J finally decided that he would order forfeiture of 6 million shares out of the 40 million then held by Sir Robert Jones and his interests. His reasoning for this was that, while in theory a forfeiture operated to compensate the remaining shareholders, in this case as the capital structure of RJI was considerable there would be little benefit in the forfeiture. By contrast, in his view, forfeiture could work to the disadvantage of former (or existing) shareholders who contemplated other compensatory proceedings since it would reduce the judgment pool potentially available.[55]

A further issue that McGechan J dealt with was the question of costs. Like Heron J he did not agree with a special regime of solicitor and client costs and he openly expressed a concern that "indemnity for costs [could] encourage excessive regulatory zeal".[56] This comment seems in marked contrast to his view in the *Gulf* judgment that the Securities Commission had a "statutory duty" to bring such an action. In any event he was prepared to award "very substantial party and party costs and disbursements" on the basis that there was "no reason why a defendant found liable should not make a substantial reimbursement to the taxpayer for costs of regulatory proceedings [which] he has rendered necessary".[57] He stated that the level of costs awarded "should enter as a factor into the overall remedy considerations".[58] In fact the costs awarded ($200,000 and up to $50,000 for disbursements) were approximately half the estimated value of the forfeited shares.[59] However, no indication was given as to the solicitor and client costs and the actual level of disbursements incurred by the Securities Commission.

4. Implications of the Case-law for the Securities Commission Act Part II

In relation to the issue of the court's jurisdiction to consider relief under section 32, the courts are clearly uncomfortable with the "reasonable grounds to suspect" test. While Sinclair J had no difficulty with the test in the *Paladin* decision he was dealing only with an application (effectively) to suspend temporarily voting rights for the voting securities until section 28 and 29 notices were complied with by various parties. Both Heron J and McGechan J have grappled with the problem and appear to have arrived at different solutions. McGechan J's solution was to accept the lower standard

55 Idem.
56 Idem.
57 Idem.
58 Idem.
59 Idem.

but to be more cautious in exercising the discretion vested in the court under section 32 (particularly where the application was for the forfeiture of voting securities). This approach effectively introduces a tiered approach to the court's powers under section 32 with some orders being able to be obtained on a lower standard, while others require more than reasonable grounds to suspect. Heron J's approach puts the onus upon the applicant to prove mitigating or aggravating factors to the normal civil standard.

Whichever approach is considered it is clear that Part II (and particularly section 30) as it is currently drafted is inadequate in setting an appropriate threshold for the exercise of some of the powers under section 32. In the author's view, section 32 should be redrafted to separate out those orders which are in the nature of interim or compliance orders, and which could rest on the "reasonable grounds to suspect" test as in the *Paladin* decision. In relation to those orders which are compensatory or punitive in nature they should be placed in another section which should clearly indicate the level of proof required before the court would exercise its discretion to order, for example, the forfeiture or disposal of the shares. If the judicial view was followed, the level of proof would be at least the normal civil standard, and one could imagine this would be buttressed by the court's reluctance to grant what is clearly seen to be a potentially "draconian" remedy.

The issue of costs should also be addressed. Currently the only reference to costs is in section 32(3)(d)(i) which provides that where shares are disposed of pursuant to an order under s.32(1)(j) the court can order the proceeds to be applied towards the costs of the application. This leaves the Securities Commission, which has brought three out of four of the actions under Part II so far, in an uncertain position. McGechan J in particular has sent out contradictory messages to the Securities Commission. On the one hand he encouraged it by not awarding costs against it when it was unsuccesful (in the *Gulf* decision) and on the other hand he expressly stated his concern about not encouraging "excessive regulatory zeal".[60] Perhaps the change in tone relates to an underlying concern that the Securities Commission in the *R E Jones* decision was being extreme in its attempts to portray Sir Robert Jones as consciously ignoring the requirements of Part II. In this instance McGechan J's found that Sir Robert's selldown was more of "a drift, occasioned by circumstances" rather than "an actual and operative selldown plan on Sir Robert's part".[61] In Australia, by comparison, there does not appear to be a concern about awarding solicitor and client costs to the regulatory body.[62]

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60 Idem.
61 Idem.
62 See *North Broken Hill Holdings Ltd* (1986) 10 ACLR 270, 287.

As practicalities dictate that most of the applications under Part II will be brought by the Securities Commission, the legislation should be clarified on the question of costs. The legislation should include a provision that allows the awarding of solicitor and client costs to any applicant, subject to the court's discretion to award a lower level of costs. However, such an amendment may be unlikely given the tendency of recent governments to allow the market to regulate itself rather than have the Securities Commission play a major regulatory role.[63]

What, in the mind of the legislature, was obviously a minor procedural part of the Securities Amendment Act 1988 has turned out in fact to be more than envisaged. The lack of thought that went into Part II is creating difficulties for both the judiciary and those persons who seek to rely upon the Act. It clearly needs far more attention than was originally given to it, particularly in relation to the questions of the standard of proof and costs.

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63 For example, the Takeovers Act 1993 provides for the promulgation of a Takeovers Code. However, the government has decided to put this aside in the light of the Stock Exchange's regulatory regime, and while it sees how the provisions in the Companies Act 1993 will work in relation to the securities markets (*New Zealand Herald,* 15 September 1993, section 3 page 1).

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