Ministry of Economic Development
Manatū Ōhanga

Reform of Securities Trading Law: Volume One: Insider Trading: Fundamental Review

Discussion Document

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Summary of Questions for Submission

1. Do you believe insider trading activity occurs in New Zealand?

2. Which of the policy justifications outlined in the paper should form the basis of our insider trading legislation?

3. Does information need to be defined? If it does:

   - Does the information have to be specific or precise?
   - Is the Australian definition of information adequate or does it need to be extended like the Singapore and Malaysian definitions?
   - Should information be able to be derived from a number of sources?

4. Should the broad or narrow approach be adopted in defining inside information?

5. Should the legislation exclude information that relates to securities generally or to issuers of securities generally?

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17. Should trading cover principals and agents?

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20. What elements should be included in the disclosure prohibition?

21. Should insiders be prohibited from disclosing inside information without lawful reason (for instance, in the proper performance of the person's employment, office or profession), even where the purpose or result of the disclosure is that the recipient does not trade?

22. Should a person lawfully disclosing inside information be required to inform the recipient that the information is inside information?

23. How should the prohibition against encouraging/advising/procuring be formulated?

24. Should liability be imposed on insiders if, on the basis of the inside information, they "discourage or stop" another person from dealing in affected securities?

25. What if any knowledge should be required in the insider trading prohibition? (Please bear in mind which penalties you believe should be imposed for insider trading and refer to Part II of Reform of Securities Trading Law Volume Three: Penalties, Remedies and Application of Securities Trading discussion document).

26. When should a body corporate or partnership be deemed to possess inside information?

27. If criminal liability is imposed should it require that a person holding inside information has used (relied on) that information in trading?

28. Should an insider be permitted to trade contrary to the inside information that he or she holds, that is, by selling [buying] particular securities while holding positive [negative] inside information concerning them?

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able to subscribe for securities under the agreement?

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34. Should the insider trading prohibitions apply to transactions in securities effected by operation of law, for example under Parts XIII and XV of the Companies Act 1993?

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38. Should there be an exception for knowledge of persons' or entities' own intentions or activities?

39. Should there be a criminal and/or civil equal information defence?

40. Should there still be an exception that allows trading by certain insiders if approved procedures are followed?

41. Should there be an exception for takeovers? To whom, and how should the exception apply?

42. Should civil liability be imposed on any person who is in control of another person who carries out impermissible trading or tipping?

43. If so, should brokers or investment advisers have an additional basis for derivative liability?

44. In light of New Zealand's commitment under the MOU and the advantages of co-ordinating our law with Australia are there strong reasons, other things being equal, for New Zealand to follow the Australian approach to insider trading law? Could you give any reasons why the costs of adopting the Australian approach (generally, or in relation to particular issues) will outweigh the benefits?

Process

This discussion paper has been prepared by the Ministry of Economic Development following consultation with other government officials and agencies. Written submissions on the issues raised in the discussion paper are invited from all interested parties. The closing date for submissions is **Friday, 30 August 2002**. After receipt of submissions they will be evaluated and further comments sought as required before the Ministry develops recommendations for the government to consider.

Submissions should be sent either by email to kirstie.drake@med.govt.nz or by hard copy to:

Reform of Securities Trading Law
Volume One: Fundamental Review of Insider Trading
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PO Box 1473
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Tel: 04-474 2887
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If sending a hard copy, please also include, if possible, a computer disk with a copy of your submission in Microsoft Word version 2000 or lower.

Official Information and Privacy Act Requirements

The contents of submissions provided to the Ministry in response to this discussion paper will be subject to the Official Information Act 1982 and the Privacy Act 1993. If the Ministry receives a request for information contained in a submission, it would be required to consider release of the submission, in whole or in part, in terms of the criteria set out in these Acts.

In providing your submission, please advise if you have any objections to the release of any information contained in your submission, and, if you do object, the parts of your submission you would wish withheld, and the grounds for withholding.

Disclaimer

Any statements made or views expressed in this discussion paper are those of the Ministry of Economic Development and do not reflect official government policy.

Readers are advised to seek specific advice from a qualified professional before undertaking any action in reliance on the contents of this discussion paper. While every effort has been taken to ensure that the information set out in this paper is accurate, the Crown does not accept any responsibility whether in contract, tort, equity or otherwise for any action taken, or reliance placed on, any part, or all, of the information in this paper or for any error in or omission from this paper.

Acknowledgement

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Introduction

Context of the Review

1. The Government has identified as one of its key objectives promoting confidence in the New Zealand sharemarket. This objective involves increasing the certainty for market participants in relation to the integrity of the market and the mechanisms for implementing the law. A number of factors can influence the level of confidence both domestic and international investors have in the New Zealand market. Strengthening the insider trading regulatory regime is only one activity geared at achieving this aim.

2. In September 2000 the Ministry of Economic Development released a discussion document that focused on the improvement of the enforcement, prevention and detection of New Zealand's insider trading law. In addition, the discussion document sought views on the definitions and substantive provisions of the Securities Amendment Act 1988 in order to test the robustness of our law and to see if there was public support for a more fundamental review of the law.

3. In response to the discussion document the majority of submitters indicated that in addition to the problems of enforcement, prevention and detection of our insider trading legislation, problems also existed with the substantive legislation contained in the Securities Amendment Act 1988. Public comment suggested that the current insider trading regime did not capture the type of behaviour that was perceived by the public to be insider trading and that a first principles review of our law was necessary.

4. The government is in the process of implementing reforms designed to improve the enforcement, prevention and detection of insider trading in New Zealand. In addition, reforms designed to improve the investigative and enforcement functions of the Securities Commission and Takeovers Panel are also underway. These are part of the Securities Markets and Institutions Bill that is currently before the Finance and Expenditure Committee and due for report back on 4 June 2002. The Bill makes a number of amendments that are designed to promote confidence in the New Zealand market by increasing the effectiveness and efficiency of the law and regulatory institutions governing securities markets, and the comparability of that law with the law of other jurisdictions.

5. In addition, this document considers a first principles review of our insider trading law. It examines the various policy justifications for implementing insider trading regulation and explores how the content of an insider trading regime could best meet and promote the policy objectives.

6. This discussion document is part of a broad programme of reforms aimed at strengthening the regulatory framework to enhance the performance of, and confidence in, New Zealand's securities trading markets. Two other discussion documents are being released for comment at this time; a document that considers whether more substantive market manipulation law should be implemented in New Zealand and a document that considers improvements to penalties, remedies and the application of securities trading law. It is envisaged that a further discussion document, which considers possible improvements to the substantial security holder disclosure regime, will also be released later this year.

7. In view of the Memorandum of Understanding on Business Law Co-ordination between New Zealand and Australia and the obvious advantages of co-ordinating New Zealand and Australian securities law, the Ministry of Economic Development has given particular attention to the Australian law when considering the issues.

Inter-Relationship with the Market Manipulation and Penalties, Remedies and Application Discussion Documents

8. Market manipulation has become a general term which deals with improper uses of the market, including actions such as manipulation of share prices, false trading and market rigging. In essence these practices all centre on ways of manipulating the market price of securities by the means of artificial market activity. The artificial market activity distorts the share price so that the reported price is less likely to reflect the underlying value of the investment. Manipulative practices tend, therefore, to distort the market making it economically inefficient and affecting investors' confidence in the integrity of the information that is available and the market itself.

9. It is appropriate at this time when we are considering a first principles review of insider trading law to also consider whether we have sufficient market manipulation law in New Zealand. Both market manipulation and insider trading are forms of market abuse that can damage the efficiency and transparency of markets and may affect market integrity and public confidence in securities trading. The procedures for detection and investigation will also be similar for both types of offences. The second discussion document on market manipulation considers our current market manipulation provisions, whether these can be improved and what, if any, further market manipulation law needs to be implemented in New Zealand.

10. Penalties that are sufficiently high and able to be effectively enforced play an important part in deterring people from engaging in illegal behaviour. Therefore, it is vital that as well as establishing clear and workable laws for market manipulation and insider trading, appropriate and effective penalties also need to be developed. For this reason the third discussion document considers the implementation of criminal and civil penalties and improvements to current civil remedies.

11. The Takeovers Act 1993 has been enacted for 8 years and Part I of the Securities Amendment Act 1988 has been in force now for 13 years. During this time there have been sophisticated developments in financial products. Further, the way in which these products, issuers of these products and markets are defined and treated by regulators has also developed and changed. For these reasons it is also appropriate to consider which financial products and entities Part I of the Securities Amendment Act 1988 and the Takeovers Act 1993 should apply to.

12. The overall goal in the release of the three discussion documents is to seek the views of the public and market participants on how to minimise market abuse in New Zealand and improve confidence in our market for both New Zealand and international investors.

The Inter-Relationship with the Proposed Legislative Changes to Enforcement, Prevention and Detection of Insider Trading

13. Adequate detection of insider trading activity and enforcement of insider trading laws are important in preventing insider trading activity from occurring. If there is a real risk of detection, successful prosecution or other enforcement action and sufficient penalties on conviction, market participants will be more likely to be deterred from engaging in insider trading activity.

14. For this reason the government is in the process of implementing reforms to make the Securities Commission a civil enforcement agency and to impose a statutory obligation on the NZSE to provide information regarding breaches of securities law to the Securities Commission. It is also considering the possibility of introducing criminal and civil penalties for insider trading and improving existing civil remedies as discussed in the Penalties, Remedies and Application of Securities Trading Law discussion document.

15. There is also a close relationship between the extent of insider trading on the one hand and the extent of timely disclosure of material information by listed companies on the other. Opportunities for insider trading will exist if a company fails to disclose material information to the market in a timely fashion. One method for preventing insider trading from occurring is to provide for continuous disclosure by public issuers. If public issuers publicly disclose price sensitive information in a timely manner, it reduces opportunities for those “in the know” to obtain a benefit from the use of undisclosed information. Further, continuous disclosure by public issuers can encourage investors to have integrity in the market by helping to counter the creation of false markets, and the distortion of markets through false or misleading rumours.

16. Requiring directors to disclose their share dealings soon after they occur also deters insider trading activity and informs and provides transparency to the market.

17. For this reason the government is in the process of implementing reforms to enact a statutory continuous disclosure regime and require directors and officers of public issuers to disclose their share dealings soon after they occur.

18. It is intended that all of these changes will assist in the enforcement, prevention and detection of insider trading and complement any insider trading law developed.

Executive Summary

Part I: Policy Justifications for the Regulation of Insider Trading

19. This Part discusses the incidence of insider trading and the various policy rationales for and against regulating insider trading. In particular, it discusses the fiduciary duty, misappropriation, market fairness and efficiency rationales and how these rationales determine the content of any insider trading regime implemented.

Part II: Background

20. This Part considers the development of New Zealand's current insider trading regime, the Securities Amendment Act 1988, and the various rationales adopted by other countries in their insider trading regimes. In addition, it provides a description of New Zealand's current insider trading law.

Part III: The Content of the Insider Trading Regime

What Is Inside Information?

21. This section considers what, if any, definition should be used to define information. It also looks at whether the broad or narrow approach should be adopted in defining inside information.

Who Are Insiders?

22. The issue discussed in this part is whether an insider is defined by using a person connection and/or an information connection approach. In particular, the different types of person connection approach and the difficulties with these definitions are discussed. In addition, the section considers the appropriate balance that needs to be reached between prohibiting harmful behaviour and stifling behaviour that can have a positive impact on the market if the information only approach is adopted.

23. Finally, this section looks at whether an insider trading regime should be restricted to natural persons or be extended to include other entities.

When Is Information Generally or Publicly Available?

24. This section looks at when information can be considered publicly or generally available. In particular, it looks at the different approaches and the difficulties in defining publicly and generally available information and discusses whether company insiders should be prevented from trading until a reasonable dissemination period has passed.

Research and Analysis

25. The importance of seeking a balance between prohibiting harmful behaviour and stifling research and analysis is discussed in this section. Issues such as whether a definition of inside information should exempt research and analysis gained from generally available information and whether a person should be able to trade before publishing their own research are discussed.

Materiality

26. This section looks at the different tests for determining when information is material (i.e. the reasonable investor, the market impact and probability tests) and considers the different standards of proof that should be required.

Application of Insider Trading Laws

27. This section considers when an insider will be liable for trading. It discusses the buying and selling of securities, whether the issue of new securities should be included and how intermediaries, principals and agents should be treated. It also considers in what situations there should be a defence for trading.

28. In addition, it considers when an insider should be liable for disclosing inside information to another party and whether there should be a defence for disclosing for lawful reasons, or where the insider did not believe the recipient would trade.

29. Finally, it considers when an insider should be liable for procuring another to trade and whether any defences to procuring should be implemented.

Knowledge and Possession

30. This section discusses when an insider is deemed to possess inside information and whether the insider needs to know the information is inside information. In particular, it considers the different tests for knowledge, when companies are presumed to hold information, whether it needs to be shown that the insider used the information in trading and what happens if someone trades contrary to inside information.

Exceptions and Defences

31. This section considers exceptions and defences to insider trading regimes. It considers exceptions for buybacks, underwriting, chinese walls, takeovers and Commission approved procedures. It also looks at an equal information defence and whether there should be exceptions for acquisitions pursuant to a legal requirement or knowledge of a persons or entity's own intentions or activities.

Civil Derivative Liability

32. This section discusses whether civil liability should be imposed on any person who is in control of another person who carries out impermissible trading or tipping and whether brokers or advisers should have an additional basis for liability.

Part I: Policy Justifications for the Regulation of Insider Trading

Incidence of Insider Trading

33. Insider trading by its very nature is difficult to detect. Statistical findings and surveys can only indicate that insider trading may be, or is likely to be, occurring in all financial markets.

34. International studies have shown that directors, senior officers and other persons connected with a cross sample of listed companies tend to purchase shares or options in their company's securities before an abnormal market price rise, or sell those securities before an abnormal market price fall more frequently than can be explained by chance.[1] Takeovers appear to provide a particular opportunity for advantageous pre-bid trading.[2]

35. Australian research also gives some support to these findings, including in the context of takeovers[3] and also indicates that some persons would be willing to engage in insider trading activity if given the opportunity.[4]

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[1] Lakonishok and Lee, "Are Insiders' Trades Informative" *Review of Financial Studies*, (2001); Jeng, Metrick and Zeckhauser*, The Profits to Insider Trading: A Performance-Evaluation Perspective,* (Harvard University Working Paper, 1999).

[2] Arnold, Erwin, Nail and Bos, *Speculation or Insider Trading: Informed Trading in Options Markets Preceding Tender Offers*, University of Alabama at Birmingham Working Paper (2000), state that corporate insiders (that is, directors and senior officers) trade prior to takeover announcements in the United States and use the options market (where it is available), as well as the equity (underlying) market. They hide their activities among those of other informed traders to avoid attracting the attention of market participants and observers. Likewise, Jabbour, Jalilvand and Switzer, "Pre-Bid Price Run-ups and Insider Trading Activity: Evidence from Canadian Acquisitions", *International Review of Financial Analysis*, 2000 argue that abnormal stock price rises at an early stage before a takeover bid's announcement are due to trading by corporate insiders in Canada.

[3] P Brown and M Foo in *Insider Trading in Australia: Evidence from Directors' Trades*, University of Western Australia Working Paper, 1998-93, report that information collated from directors' disclosures of changes in their interests in their own companies (under s 205G) suggests a tendency for Australian directors' sales (but not purchases) to be profitable. In particular, directors' sales tend to occur after abnormal price rises and are followed by abnormal price declines. I.D. Watson and A. Young in *A Preliminary Examination of Insider Trading around Takeover Announcements in Australia*, University of Western Australia Working Paper (1999), 113 report that, relative to other times, directors of ASX-listed target companies buy more often and in larger parcels before the announcement of a takeover bid and are sellers after the announcement. Increased buying activity occurs several weeks before the announcement and then again in the last week prior to the announcement.

[4] Just over half the respondents to a 1995 survey of senior corporate officers conducted by M. Freeman and M. Adams expressed a willingness to buy before a company's favourable announcement. Also, some 44% were more likely to buy a target company's shares before a takeover announcement. Just under half of those respondents said that they would trade to be rewarded for entrepreneurial skill and two thirds of that group said that they may do so even if it meant trading on inside information: M. Freeman and M. Adams, "Australian Insiders: Views on Insider Trading," *Australian Journal of Corporate Law* 10 (1999): 148. The authors concluded that either the majority of senior insiders surveyed would commit insider trading if given the opportunity (given their belief that

36. As well as the changes in trading patterns, countries have frequently relied on surveys and anecdotal evidence to show that market participants perceive insider trading to be a problem in their markets. Submissions made on the Ministry of Economic Development's discussion document, released in September 2000, provided anecdotal evidence that the majority of submitters believed that insider trading exists in the New Zealand market and that it can undermine confidence in our market.

37. The likely existence of insider trading has resulted in an international trend to prohibit insider trading activity on financial markets by strengthening insider trading laws. Over 80% of countries with stock markets, including all OECD countries, have insider trading laws. Most countries treat insider trading as a criminal offence. New Zealand stands out as one of few countries that has not made insider trading a criminal offence. Further, many jurisdictions have moved within the last decade to introduce, or significantly strengthen, their insider trading laws. For many countries this has also involved introducing or strengthening civil remedies. Currently the Singapore Monetary Authority and the Commission of European Communities are looking at reviewing and strengthening their insider trading regimes and the Companies Securities and Advisory Committee in Australia is looking at possible adjustments that could be made to the Australian regime.

Arguments For and Against Insider Trading?

38. If we believe that insider trading is occurring, then we need to examine whether insider trading has a positive or a negative impact on financial markets and whether we believe it is necessary to legislate against it.

Arguments against the Regulation of Insider Trading

39. Opponents of insider trading regulation argue that insider trading is valuable for investors as it makes securities markets more efficient by communicating earlier to the market the existence of inside information (optimal disclosure) and is an efficient way to compensate corporate management (efficient means of remuneration).[5] Further, opponents believe that insider trading legislation is ineffective and difficult to enforce, and that there may be cheaper private alternatives to legislating against insider trading activity.

Optimal Disclosure

40. Under this rationale it is argued that there are many valid reasons for companies to disclose information about their future earning prospects, but that companies cannot disclose such information when their earning prospects would be harmed by

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the prohibition was inadequate) or the respondents did not regard what they were doing as insider trading.

[5] See H. Manne, *Insider Trading and the Stock Market*, 1966; S. Bainbridge, "The Insider Trading Prohibition: A Legal and Economic Enigma," *University of Florida Law Review* 38 (1986): 35; and in New Zealand, B. Wilkinson, "Insider Trading Legislation: Weak Analysis and Troubling Outcomes" in *Essays on Insider Trading and Securities Regulation*, ed. Rickett and Grantham (1997), 170.

the disclosure. If insiders buy company shares, those who are observing the price movements may infer that insiders are optimistic about the company's prospects and may in turn buy shares that may increase the price even further. Insider trading activity, therefore, may lead the price to move in the direction of the undisclosed information, making the price a better indicator of value. In this way a company can use insider trading to communicate changes in fortunes to the market without disclosing sensitive information.

Efficient Means of Remuneration

41. Under this rationale it is contended that permitting insider trading provides managers with an incentive to increase the value of shares of the company that employs them, because insider trading will allow them to profit from a rise in its share price. Further, a company's board or shareholders can reduce the remuneration formally paid to managers (salary and bonuses) if it permits insider trading. This, opponents believe, undermines the argument that insider trading is unfair profit at the shareholders' expense.

Insider Trading Legislation Is Ineffective and Difficult to Enforce

42. Opponents also argue that insider trading legislation is ineffective and difficult to enforce and has little impact on securities markets. Low enforcement rates and few convictions against insiders have been cited as evidence of this ineffectiveness. Difficulty of detection of insider trading activity is also considered a factor adding to poor conviction rates.[6]

Private and Cheaper Alternative

43. Finally, opponents argue that insider trading legislation overlooks the private and cheaper alternative of limiting insider trading activity through private contracts. Private confidential contracts are seen as much easier to enforce and to allow individual firms to evaluate if insider trading restrictions will add to the company's value.[7]

Justifications for Regulating Insider Trading

44. There has been much debate around why insider trading should be prohibited. Some people have disagreed with the arguments raised by opponents to the regulation of insider trading. It has been contended that if insiders were freely permitted to insider trade, insiders may let the prospect of financial gain influence what they recommend their company undertake and when. For example, directors may suppress a company's intentions from the market in order to buy more time to finance their trading.

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[6] M.A. Freeman, M.A. Adams, and L. Semaan "Insider Trading a Necessary Evil for Efficient Markets? An International Comparative Analysis" *Company and Securities Law Journal*, vol 17: 26-227.

[7] Ibid., 227.

45. Further, it has been argued that there are better ways of rewarding directors than by permitting them to exploit their knowledge of the company's confidential information. Paying higher salaries, bonuses, or openly subsidising share ownership have been identified as preferred options for rewarding directors. The efficient means of remuneration argument may only be valid if the share price of a company is relatively stable. A volatile share price may discourage managers wishing to avoid risk and make compensation for their work look more attractive. Finally, it is argued not all insiders may deserve the reward they receive from insider trading.

46. Most jurisdictions have accepted that insider trading is wrong and should be unlawful, however, the rationales behind insider trading law differ between jurisdictions. Four rationales have been put forward for the need to regulate insider trading. These include:

- fiduciary duty;
- misappropriation;
- market fairness; and
- market efficiency.

47. The fiduciary duty and misappropriation rationales, focus on the misuse of information by persons having some fiduciary or similar relationship with a company whose securities are traded or the owner of the information. The market fairness and efficiency rationales focus on the market impact of using inside information.

Fiduciary Duty

48. The fiduciary duty theory is based on the idea that:

> "a person who owes fiduciary duties to a company should not make a personal profit or avoid loss by using a company's price sensitive information to trade in securities. This trading may breach various fiduciary duties, including the duty of confidentiality, the duty not to use corporate information for personal gain and the duty to avoid conflicts of interest. This trading may also adversely affect the commercial standing or reputation of the company, including the value of securities."[8]

49. The fiduciary duty theory results in legislation that requires a person to have a relationship with the entity that holds the inside information in order for the person to be considered an insider (a person connection approach). This theory has been developed primarily by the United States Courts. New Zealand's current insider trading regime (Part I of the Securities Amendment Act 1988) is a modified version of the fiduciary duty rationale, namely breach of confidence.

50. The fiduciary duty theory has been considered by some as not providing an adequate justification for many common aspects of insider trading law. First, it does

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[8] Companies and Securities Advisory Committee *Insider Trading Discussion Paper*, (June 2001), 1.14.

not cover persons who are privy to similar valuable information, as those in the traditional fiduciary relationship, but who have other relationships with the company.

51. For example, the fiduciary duty theory would not prohibit an officer of a prospective bidder company, or an employee of a third party connected with the bidder company, from trading on-market in the shares of a target company prior to the disclosure of a takeover bid.

52. Further, breaches of fiduciary duties imposed in most other relationships, such as partnerships, result in civil not criminal remedies. Despite this fact many jurisdictions have imposed criminal penalties on fiduciary duty based insider trading regimes.

53. Finally, if insider trading is based on a breach of a private duty then it should be open to the parties to the relationship to modify, extend or even exclude that duty (for example the duty may be modified to permit an insider to trade with an informed counterparty). However, most insider trading legislation that adopts the fiduciary duty rationale is mandatory.

Misappropriation Theory

54. The misappropriation theory focuses on protecting the rights of owners of information, not participants in the market. The theory is based on the idea that the use of confidential price-sensitive information is wrong because it is a misappropriation of private information from the entity to which it belongs.

55. This theory prohibits trading by a person who is entrusted with non-public information by another person to whom they owe a fiduciary duty, or who gives the information to them on the basis that they will hold it in confidence. The theory applies regardless of whether the individual is a company insider or someone who owes a duty to the other party to the transaction.

56. Like the fiduciary duty theory, the misappropriation theory was developed by the United States Courts. The theory encompasses and extends the fiduciary duty theory, as the owner of the information may not necessarily be the entity in whose securities are being traded. Indeed in some instances, the inside information may be deliberately withheld from that entity. For instance, a prospective bidder company would be the owner of any confidential information that it intends to conduct a takeover bid for a target company. The misappropriation rationale would therefore extend to an officer of a prospective bidder company who traded in target company shares.

57. The misappropriation theory also has a number of limitations. A person will only breach the insider trading prohibition if the user of the information breaches a fiduciary duty to the owner of the information (or possibly has stolen the information). In many jurisdictions this has led to artificial reasoning in order to establish this fiduciary relationship between the user and owner of the information. For example, in the United States case of *United States v Willis*,[9] a psychiatrist traded on the basis of information learned from a patient. In applying the misappropriation rationale, the

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[9] *United States v Willis* 737 F.Supp.269 (S.D.N.Y., 1190).

Court relied in large measure on the Hippocratic Oath to establish a duty by the psychiatrist not to use the inside information obtained from the patient. The reasoning in this case seems strained.

58. It is also often unrealistic to suggest that insider trading may always be regarded as a form of theft. One person's use of information will often have little effect on the marginal cost of the use of that information by some other person. An insider who buys shares ahead of a positive announcement usually inflicts no harm on the corporation. Further, the misappropriation theory presupposes the allocation of property rights in information to the corporation or the shareholders. It does not answer the question as to who should be entitled to the property right itself.

59. Finally, in many countries there will be no breach if the user discloses his or her trading intentions to the owner prior to trading (under the United States provisions) or if the owner approves that use. In any of these cases, the user could trade with an uninformed counterparty free of any constraints.

Market Fairness

60. The market fairness principle (also sometimes called the equal access to information approach) suggests that all investors in a market should have an equal opportunity to obtain and evaluate information relevant to their trading decisions. This principle provides a wider prohibition on insider trading than the fiduciary duty and misappropriation rationales.

61. All investors face trading and other risks when participating in the market. However, inevitably some market participants will have better resources or expertise in the gathering of information and a better capability to interpret the information. This means that there will always be some investors with a trading advantage over others.

62. The market fairness theory does not attempt to address the advantage of superior skill, time or commitment that one investor may have over another. Instead it is directed to preventing an insider from having an information advantage that is not derived from research or analysis of publicly available information. It prevents an insider from trading on the basis of information obtained from a non-public source, since that information allows the insider an information advantage.

63. It is the fact that an insider has price sensitive information by itself that underpins the prohibition against trading while that information remains unavailable to the market as a whole.

64. The key to this theory is the need to determine when trading on the basis of confidential price sensitive information is unfair.

Market Efficiency

65. This theory is based on the idea that insider trading activity may damage financial markets in a number of ways. These include:

- As stated above insiders may delay disclosure of price-sensitive information to give themselves time to trade (for example directors may suppress a company's intentions from the market in order to buy more time to finance their trading);

- If investors believe that insider trading exists, and goes unpunished by either weak or non-existent insider trading laws, they may presume that securities are the domain of those with access to privileged information and that others will miss out as the gains go to insiders. This may reduce the incentive for local and foreign investors to participate in any market that gives a special trading advantage to holders of confidential price-sensitive information. Reduced market participation may have adverse effects on the overall liquidity of financial markets and the fundraising functions of those markets.[10]

- Any move towards permitting insider trading may encourage persons to trade on false assumptions that key market participants have inside information, rather than proper financial fundamentals. This could create opportunities for exploitation.

Comment

66. The fiduciary duty and misappropriation rationales are more narrow in their scope as they require that an insider have some fiduciary or similar relationship with a company whose securities are traded or the owner of the inside information (if the company is not the owner). The market fairness and market efficiency rationales have a broader scope as they focus on the impact on the market of using inside information.

67. There needs to be a clear policy justification for insider trading law in New Zealand. A clear policy justification is fundamental to the appropriate development and application of insider trading laws and helps to ensure that the purpose of the legislation is transparent and the regulation itself is consistent, and workable. Lack of clarity in insider trading law may result in reduced compliance as well as unproductive uncertainty for the market.

68. The basis or rationale behind insider trading legislation determines the content of any legislation that is implemented. For example a fiduciary relationship rationale requires there to be a connection with the public issuer, while a regime based on market fairness and efficiency may not require this person connection and may have to have a wider range of exceptions.

Questions for Submissions

1. Do you believe insider trading activity occurs in New Zealand?

2. Which of the policy justifications outlined above should form the basis of our insider trading legislation?

[10] U. Bhattacharya and H. Daouk, *The World Price of Insider Trading*, Working Paper, (Indiana University, 2000), found that the cost of equity in a country is reduced by about 5% if insider trading laws are enforced. The results also suggest that countries that enforce insider trading laws have more liquidity in their market.

Part II: Background

Development of the Securities Amendment Act 1988 and International Experience

69. Most of New Zealand's insider trading law is found in Part I of the Securities Amendment Act 1988. Until the passing of the Securities Amendment Act 1988 New Zealand did not have specific legislation dealing with insider trading.

70. The enactment of the Securities Amendment Act 1988 was prompted by the Government's concern about the state of the securities markets during the mid-1980's following the deregulation of the New Zealand economy. The Act was based on a report the Securities Commission presented in 1987.

71. This report recommended that "statutory cause of action should be established to enable companies and persons who deal with insiders to obtain, by means of civil proceedings, redress for the mis-use of information that is held in confidence."[11]

72. The Securities Commission report demonstrates a modified version of the fiduciary duty rationale, namely breach of confidence and explains why our current legislation requires a connection between the public issuer and the insider, and has civil remedies.

73. The New Zealand regime was based on concepts similar to those identified at the time as underlying the regime of the United States. The United States insider trading regime has been developed by the United States Courts, however the United States Courts have yet to come to a consensus on what the rationale behind prohibiting insider trading should be. Originally the fiduciary duty rationale was predominant (at the time when the Commission released its report), however, the courts and the Securities and Exchange Commission ("SEC") have also developed the misappropriation rationale.

74. A few of the United States Courts have even recognised a market fairness or market efficiency approach. The SEC has also pointed to the adverse effect on market fairness and market efficiency if disclosures of confidential price sensitive information are limited to a number of persons or insider trading is permitted.

75. In contrast to the United States, the Australian regime provides a clear policy basis for its insider trading legislation. The 1989 Parliamentary Committee Report on insider trading (the Griffiths Report) rejected the notion that the scope of insider trading laws should be limited to some concept of fiduciary duty or a theory of misappropriation. Instead, the report stated that the basis of the insider trading prohibition on insider trading is investor confidence in the market, that is, a combination of the market fairness and efficiency rationales.

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[11] New Zealand Securities Commission *Insider Trading- Report to the Minister of Justice* 1987, Vol. 1, 74 and 95 (Insider Trading Report).

76. While other countries' legislation reflects the market fairness and efficiency principles (see for example the Preamble to the European Union 1989 Council Directive on Insider Trading, and the law in Singapore, Malaysia and the United Kingdom), predominantly other countries still base their insider trading regimes on the narrower fiduciary duty and misappropriation rationales.

Description of New Zealand's Insider Trading Law

77. New Zealand's insider trading law is found in three sources, the most important of which is Part I of the Securities Amendment Act 1988.

78. At common law, in certain circumstances a shareholder can recover losses from a director of a company, where the director purchased shares from the shareholder while having material information not available to the shareholder. However, a fiduciary relationship or other special relationship between the parties is necessary. These relationships are usually not present between parties to a market transaction.[12]

79. The Companies Act 1993 also contains provisions relevant to insider trading:

- Section 145 restricts the use of company information by company directors;
- Section 148 requires directors to disclose share dealings to the board and these disclosures must be entered in the company's interest register and disclosed in the annual report; and
- Section 149 requires the sale and purchase of securities by a director who has material information in his or her capacity as a director or employee of the company to be at fair value determined on the basis of all information known to the director or publicly available. This section does not apply to a company to which Part I of the Securities Amendment Act 1988 applies.
- Section 60(3) requires that a board making an offer to acquire shares must not be aware of any information that it has not disclosed to shareholders which is material to an assessment of the value of the shares and would result in the terms of the offer and the consideration offered for the shares being unfair to shareholders accepting the offer.

80. Part I of the Securities Amendment Act 1988 contains the main provisions relating to insider trading in New Zealand.

81. The Act applies to a company or any other entity that is or was listed on a stock exchange registered in New Zealand when the action or event occurred. The key definitions in the Act are:

- "Inside Information" in relation to a public issuer means information that is not publicly available but would or would be likely to affect materially the price of securities of the public issuer if it were publicly available;

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[12] See *Coleman v Myers* [1977] 2 NZLR 225.

- "Insider" means, in relation to the public issuer,-
    - the public issuer itself;
    - a director or employee or substantial security holder of the public issuer who has inside information about the public issuer or another public issuer by reason of their position with the public issuer; or
    - a person who receives in confidence inside information about the public issuer or another public issuer from any of the persons referred to above (or from a person who has received the information in confidence from any of the person referred to above).

Insider Dealing

82. Under section 7, an insider who has inside information about a public issuer and who buys or sells securities is liable to:

- The person who sold or bought the securities, for any loss incurred by that person; and
- The public issuer, for the amount of any gain made or loss avoided by the insider plus a pecuniary penalty (but the penalty is not to exceed the greater of the consideration for the securities, or three times the amount of the gain made or the loss avoided by the insider).

83. There are the following exceptions from section 7:

- If the securities are bought or sold by a director, company secretary, or employee of the public issuer in accordance with a procedure approved by the Commission;
- If the purchase of securities results from a takeover offer made under the Takeovers Code; and
- If the sale or purchase of securities was made in accordance with appropriate "chinese wall" procedures.

84. Sections 11 and 12 provide for similar liability, and exceptions, in respect of dealings by an insider of a public issuer who has inside information about another public issuer. Section 12 provides an additional defence to liability under section 11 if the public issuer of which the person is an insider consents to the buying or selling of the securities of the other public issuer.

Tipping

85. Under section 9, an insider who has inside information about a public issuer and who encourages another person to buy or sell securities, or provides information to a person believing that the tippee will buy or sell securities, is liable to:

- any person who sells or buys securities to or from the tippee, for the loss incurred by that person; and
- the public issuer, for any consideration or benefit received by the insider, any gains made or losses avoided by the tippees, and a pecuniary penalty (but the penalty is not to exceed the greater of the consideration for the securities, or three times the amount of the gain made or the loss avoided).

86. There is an exception to section 9 if the person acted in accordance with a "chinese wall" procedure.

87. Sections 13 and 14 contain similar provisions to tipping about securities of another public issuer.

Legal Opinion

88. Under section 17, a shareholder or former shareholder of a public issuer may, with the prior approval of the Commission, require the public issuer to obtain an opinion from a lawyer on whether or not the public issuer has a cause of action against an insider. The public issuer is required to supply all relevant information to the lawyer, and must pay the lawyers fees. The government has announced an intention to repeal section 17 of the Act. However, it is intended that an amendment will be made to the Act to require the public issuer, or directors of the public issuer to provide information to shareholders undertaking a section 18 action.

Derivative Actions by Shareholders

89. Under section 18, a public issuer's right of action against an insider may, with the leave of the High Court, be exercised by a shareholder or former shareholder of the public issuer. The public issuer must pay the costs of person to whom leave is given.

Distribution of Amount Recovered by Public Issuer from Insider

90. Under section 19, any money recovered by a public issuer from an insider must be held by the public issuer on trust for distribution in accordance with the directions of the High Court. The Court may order that the amount be distributed to shareholders or former shareholders, retained by the public issuer, or paid for charitable purposes.

Part III: The Content of the Insider Trading Regime

What Is Inside Information?

91. There are two important issues to address when considering what is inside information. These include:

- What constitutes information; and
- Should a broad or narrow approach towards inside information be adopted.

What Constitutes "Information"?

92. The Securities Amendment Act 1988 does not contain a definition of information. A Securities Commission report stated that "in many cases a hint may suggest information or may enable an inference to be drawn or a deduction made which could only be made about an insider."[13]

93. The Australian definition of "information" states that information includes "matters of supposition and other matters that are insufficiently definite to warrant being made known to the public and matters relating to the intentions or likely intentions, of a person."[14]

94. The Australian definition is an inclusive rather than exhaustive definition, "information" can include other types of information not defined. However, the Australian definition is constrained by the definition of materiality set out in section 1042D. Section 1042D provides that "a reasonable person would be taken to expect information to have a **material effect** on the price or value of particular Division 3 financial products if (and only if) the information would, or would be likely to, influence people who commonly acquire Division 3 financial products in deciding whether or not to subscribe for, buy or sell the …securities."

95. The Australian definition of information has been adopted in the Malaysian legislation and the proposed Singaporean legislation. However, these jurisdictions take the definition of "information" one step further to make information cover such things as:

- matters relating to negotiations or proposals with respect to negotiations or proposals with respect to commercial dealings or dealings in securities; and
- matters relating to the future.

96. United States and New Zealand laws also suggest that information can come from a number of sources. In *Kincaid (No 2)*[15] the Court indicated that it was prepared

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[13] Securities Commission, *Report of an Inquiry into Aspects of the Affairs of Regal Salmon Ltd Including Trading in Its Listed Securities* (1984), para 22.38(a).

[14] Section 1042A(1) of the Corporations Act 2001.

[15] *Kincaid v Capital Markets Equities Ltd (No 2)* (1995) 7 NZCLC 260.

to infer that inside information existed by the collection of number of pieces of information which gave rise to a concern about the bank's financial situation prior to a final determination that there was a problem.

97. Under United States Law inside information can also include a "mosaic" of different pieces of information, none of which in isolation may be precise or conclusive.

98. All of these definitions demonstrate a general approach to information. Information includes inferences, hints and matters of supposition, as well as an element of knowledge. It is not limited to the ordinary meaning of facts as they are precisely stated.

99. This general approach to information contrasts with the United Kingdom and South African definitions of "inside information" which require that information be specific or precise. These definitions are designed to exclude rumours, suspicions, conjecture or speculation from the definition of inside information.[16] Information can be specific, even though it may be a vague or imprecise. For example, a person may have specific knowledge of an imminent rights issue but may not know the precise details of the issue.

100. It has been argued that the more specific and prescriptive the test or definition for information implemented the more likely it is that technical arguments will be raised about what is considered information in subsequent litigation. In fact some consider the danger in defining a term which embraces such a wide concept is so great that is should not be defined at all except to the extent necessary to provide exceptions to the definition. For example, if the market and efficiency rationales are to be adopted with the information connection approach only it may be necessary to define information in order to exclude such things as research and analysis. On the other hand one risk of not defining the term information is that it may be defined more narrowly than anticipated by the Courts at a later stage.

Questions for Submissions

3. Does information need to be defined? If it does:

- Does the information have to be specific or precise?
- Is the Australian definition adequate or does it need to be extended like the Singapore and Malaysian definitions?
- Should information be able to be derived from a number of sources?

[16] P. Osode, "The New South African Insider Trading Act: Sound Law Reform or Legislative Overkill?" *Journal of African Law* 44 (2000): 243.

The Broad or Narrow Approach Towards Inside Information

101. There are two types of inside information that have been identified:

- Non-public price-sensitive information derived from within the entity whose securities are traded (the narrow approach); or
- Any non-public price-sensitive information affecting particular securities that is not available to the market regardless of its source (the broad approach).[17]

102. Under the narrow approach the information is internally generated by the entity concerned, while both internally and externally generated information constitutes inside information under the broad approach.

103. Examples of externally generated price-sensitive information would include advisers trading in advance of conveying their trading recommendations to clients (scalping) or advisers transacting on their own behalf before implementing clients instructions (frontrunning). The broad approach may also cover price-sensitive information generated by one entity that also affects the price or value of securities of another entity. For example, information about a raider's intentions to bid for the securities of a target company.

104. The adoption of a narrow approach to inside information, therefore, can restrict the ambit of the insider trading provisions by excluding the above situations.

105. The United States, Australia, and Germany (among others) all adopt the broad approach to defining what is inside information, with no requirement for the company whose securities are traded to have generated the inside information. The closest country to a narrow approach is probably the New Zealand position. In New Zealand while there is no requirement that inside information be generated or sourced from the company, a primary insider is only an insider if he or she has inside information about a public issuer by reason of his or her position with an issuer.

106. If it is decided to adopt the broad definition of inside information there is an issue as to whether it should be qualified to make it clear that it covers only non-public price sensitive information that relates to a company or its securities, rather than information that has only a general market application.

107. For example, there is some information about general economic or other developments may have an impact on the price of a particular company's securities as well on the market more generally.

108. The United Kingdom definition excludes this type of information. It adopts the broad approach towards inside information, however, its definition of inside information excludes any information that relates only to securities generally or to issuers of securities generally.

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[17] Companies and Securities Advisory Committee *Insider Trading Discussion Paper*, 19.

Questions for Submissions

4. Should the broad or narrow approach be adopted in defining inside information?

5. Should the legislation exclude information that relates to securities generally or to issuers of securities generally?

Who Are Insiders?

109. Identifying who is considered an insider is a fundamental part of any insider trading regime. There are two main issues to consider when formulating a definition of "insider":

- Should the definition include a "person connection" and/or "information connection" approach?; and
- Should the definition of "insider" be limited to a natural person or extended to include other entities?

The "Person Connection" and "Information Connection" Approaches

110. The policy rationales underpinning an insider trading regime play an important part in determining who is considered an insider. Many regimes, including New Zealand's Securities Amendment Act 1988, define their insiders as someone who has a relationship (direct or indirect) with the issuer of the securities. The approach also generally distinguishes between primary and secondary insiders.

111. The application of the prohibition on insider trading in these cases is linked to the fiduciary duty or misappropriation rationales. Insider trading is considered inconsistent with a fiduciary or similar duty owed to the entity whose securities are traded or the owner of the inside information.

112. The tests for the person connection approach differ between jurisdictions. Essentially the person connection tests fall into three categories for primary insiders. These include the direct connection, employment and fiduciary duty approaches.

113. The direct connection approach requires the person to have a direct connection to the entity whose securities are affected by the inside information (examples include the company itself, a director or a shareholder). The employment approach requires a person to have access to inside information by reason of their employment, office or profession. Finally, the fiduciary duty approach requires a person to have a fiduciary or similar duty to the entity whose securities are traded, to the counterparty or the source of the information.

114. Secondary insiders are generally defined as persons who obtain inside information from a primary insider or another secondary insider.

115. The Securities Amendment Act 1988 adopts a "person connection" approach that applies to primary and secondary insiders. The New Zealand regime, along with a number of overseas regimes, defines a primary insider as someone who has a relationship with the issuer and who has information, by reason of that relationship, in circumstances where the price of the securities is likely to be sensitive to the release of the information. The issuer does not need to be the source of the information. Primary insiders include the public issuer itself, a director of the public issuer, officers of the public issuer, an employee of the public issuer, a substantial security holder.

116. Secondary insiders are generally defined as persons who obtain inside information in confidence from a primary or secondary insider. The category of secondary insiders is limited to persons who are not more than two removed from the primary insider.

117. The Securities Amendment Act 1988 in determining who has a person connection with the public issuer deems certain people to have an information connection. Under the Act a person is presumed to be an insider under sections 3(1)(b)(d) or (f) if the person holds inside information by reason of a position with an issuer. Sections 3(2), (3) and (4) create a presumption that any information held by that person is held by reason of that position, unless the contrary is proved. That means that people connected to the public issuer will be deemed to possess inside information unless evidence is produced to the contrary. Accordingly, the onus is shifted on to the specified persons to produce evidence that the information they possessed was obtained other than by being a principal officer, company secretary, or substantial security holder of the public issuer or another insider (i.e. that no duty was breached).

118. The definitions of primary and secondary insiders under the New Zealand legislation, and other overseas regimes have become long and complex. This has often resulted in technical arguments about their application and created possible ways for people to avoid them. It was concerns of this kind that motivated the design of the current Australian insider trading regime.

119. Problems with the Securities Amendment Act 1988 definition of "insider" were highlighted by the recent Securities Commission insider trading inquiry into the trading in the shares of Fletcher Challenge Limited in May 1999.[18] In that case the subjects of the investigation were not considered insiders under the Act as they were both too many steps removed from the source of the information. Public and media comment, however, indicated that many people thought their actions should be considered insider trading activity.

120. Under the information connection approach anyone who has material price-sensitive information that is not generally available is considered an insider,

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[18] New Zealand Securities Commission *Insider Trading Law and Practice: Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited* (May 1999).

regardless of their relationship to the source of the information.[19] The Australian insider trading regime adopts only the information connection definition of insiders.

121. Unlike the person connection approach the information connection approach does not distinguish between primary and secondary insiders. It applies to any person who possesses information and who "knows or ought reasonably to know" that the information "is not generally available" and "might have a material effect on the price or value" of securities. If these tests are satisfied it makes no difference how, or from whom, that person has obtained the information. It covers all situations where a person knowingly obtains inside information, even by chance.

122. This information connection approach reflects the Australian insider trading regime policy rationales of market efficiency and fairness. As the Australian regime focuses on the market impact rather than a fiduciary or similar relationship with a company whose securities are traded, it does not require an insider to have a relationship with the source of the information. It is considered trading with knowledge while in possession of information, not a person's connection, which can detrimentally affect the market.[20]

123. The Australian regime by its adoption only of the information approach without any person connection has some interpretative freedom and allows them to dispense with the practical difficulties of proving the "person connected" criteria, which can be complex, uncertain, and lead to gaps in coverage.

124. However, the market fairness and efficiency rationale creates a broader net of potential defendants because the information connection only approach defines insiders as anyone who has confidential price sensitive information. The disadvantage of this approach is that it has the potential to stifle innovative research and analysis of matters impacting on company and market performance by preventing analysts from identifying mis-priced securities and trading on those securities accordingly. This creates a risk that the price may not reflect the fair value and market efficiency may be damaged.

125. This risk is mitigated to some degree by exceptions for research and analysis and by considering the appropriate balance that needs to be reached between prohibiting harmful behaviour and stifling behaviour that can have a positive impact on the market. These issues are discussed in some detail in the section at paragraph 157.

126. Some jurisdictions (Malaysia, Singapore in its draft Securities and Futures Act 2001, and the United Kingdom Financial Services and Markets Act s118) have followed the Australian model by adopting an "information connection" approach to

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[19] While any person in possession of inside information is not permitted to trade, in Australia, at least for criminal prosecutions insiders have a specific equal information defence to a criminal prosecution see paragraphs 313-322.

[20] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Fair Shares for All: Insider Trading in Australia* (11 October 1990), paras 4.7.1-4.7.9.

who is considered an insider. However, many jurisdictions still adopt a "person connection" approach that distinguishes between primary and secondary insiders.

Questions for Submissions

6. Should the definition of who is considered an insider be based only on the information connection approach (like Australia) or include a person connection?

7. If a person connection approach should be included, what should the test be?

8. Should certain people be presumed to have inside information by reason of their position?

Application to Natural Persons and Entities

127. The Securities Amendment Act 1988 applies to natural persons, corporations sole, companies or other bodies corporate (whether incorporated in New Zealand or elsewhere), unincorporated bodies of persons, public bodies, and Government departments.

128. Included in the Securities Amendment Act 1988 are chinese wall defences. Chinese wall defences allow situations where one department or section of an entity has access to unpublished price-sensitive information about the securities of a public issuer and other departments of the entity, who have been kept ignorant of the information by a chinese wall, are allowed to deal in the securities.

129. Most other international jurisdictions also have insider trading regimes that apply to a range of entities rather than restrict the application of the regime to natural persons. These regimes also have chinese wall defences that allow entities to trade where someone in their organisation holds confidential price-sensitive information.

130. By contrast the United Kingdom and South African laws only apply to natural persons ("individuals"). However, these persons are liable whether they act on their own behalf or on behalf of some other person or entity. This ensures that an individual cannot avoid the insider trading provisions merely by using a corporate or other entity to trade.

131. The main reason put forward for restricting the insider trading prohibition to natural persons is that it avoids the difficulties with chinese wall defences. There have been difficulties for many jurisdictions in implementing workable and effective chinese wall defences.[21] A more in-depth discussion of the pros and cons of chinese wall defences is discussed in the exceptions part of this paper at paragraphs 301 - 309.

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[21] *Final Report by the King Task Group into Insider Trading Legislation*, (October 1997), para 3.12.

132. The main reason put forward against restricting the prohibition to natural persons is:

> "the current prohibition obliges entities to create communication barriers between their research and trading sections in order to attract the Chinese Walls defence. Limiting the legislation to natural persons could undermine any incentive for entities to control the flow of information within their organisations."[22]

133. Not extending the prohibition to corporations may lead to impractical consequences. There is already wide spread concern about the approach of investment banks and broking houses to, for example analyst's recommendations where the analyst's employer is seeking to obtain, or has already obtained, investment banking work from the corporation in whose shares the analyst has expressed, often, a positive view (and is perceived to be under pressure to do so). There is a market expectation that industry players should not be put in a position where they can abuse their (perceived) favoured position of access to information.

134. Limiting the legislation to natural persons may enable entities to issue their own securities without being subject to the insider trading prohibition (if it is determined that the insider prohibition should apply to the issue of new securities). Investors may need some protections against the possibility of an entity issuing securities without disclosing material price-sensitive information. Although the Securities Act 1978 does contain provisions that offer protections against misleading or incomplete offering documents (see the discussion on the issue of new securities at paragraphs 194 - 206).

Questions for Submissions

9. Should the definition of insider be restricted to natural persons or should it include natural persons, companies, other bodies corporate, public bodies etc?

When Is Information Generally or Publicly Available?

135. It is fundamental to the concept of insider trading that the information that an insider trades on is not generally or publicly available to other investors in the market.

136. Under section 2 of the Securities Amendment Act 1988 inside information is information which is not "publicly available." There is no definition of "publicly available" included in the Act. This raises questions about the scope or number of persons to whom information should be available before it is considered "publicly available."

137. The Securities Commission has commented that:

> " The [Securities] Amendment Act envisages that the degree of disclosure required for the information to be "publicly available" is such that it will be likely to affect the price of

[22] Companies and Securities Advisory Committee *Insider Trading Discussion Paper,* para 1.55.

> securities of the public issuer if the information is of a price sensitive nature. In order for information to be given the opportunity to affect prices it seem sensible that the information must be disclosed to the market generally. This supports the view that the term "publicly available" should be interpreted as meaning available at least to participants in the market in which the securities are traded, and probably also to potential participants, those who might act on the information."[23]

138. The Commission's position is similar to that held in the United States Court of Appeals for the 2nd Circuit in SEC v Texas Gulf Sulphur Co that "before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to insure its availability to the investing public.[24]

139. In the United States material information becomes public in either of two ways. The first view is that information that is disseminated and absorbed by the investment community is public. The second view is that information is deemed public when the active investment community is aware of such information. Under the second view information that is known by the investment community will be reflected in the price of an efficiently traded security.

140. The New Zealand Court in Wilson Neill considered the price sensitivity of information (which was alleged to be inside information) to be debatable since the "market knew or was readily able to infer the general nature of Wilson Neill's problems."[25] The court did not require specific disclosure of information before finding information was already in the public domain.

141. The Court has also relied upon evidence of market prices during the relevant period to show that the market was aware of the problem and that the information was in the public domain.

142. Section 58(2) of the Criminal Justice Act of the United Kingdom provides a set of circumstances that make it clear when information is made public. Section 58(2) states that information is made public if:

(a) it is published in accordance with the rules of a regulated market for the purpose of informing investors and their professional advisers;

(b) it is contained in records which by virtue of any enactment are open to inspection by the public;

(c) it can be readily acquired by those likely to deal in securities;

  (i) to which the information relates; or

  (ii) of an issuer to which the information relates; or

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[23] *Insider Trading Law and Practice: Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited*, 24.

[24] 401 F.2d 833 (2d Cir.1968).

[25] *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2NZLR 161.

(d) It is derived from information which has been made public.

143. Under section 58(3) information may be treated as made public even though-

(a) it can be acquired only by a person exercising due diligence or expertise;

(b) it is communicated to a section of the public and not to the public at large;

(c) it can be acquired only by observation;

(d) it is communicated only on payment of a fee; or

(e) it is published only outside the United Kingdom.

144. The problem identified with the United Kingdom definition is that by listing the methods whereby people can make known information the definition may be seen as providing an exhaustive list of circumstances and not provide for all eventualities. Further, it would require frequent updating to keep abreast with developments in the fast moving securities industry.

145. The Australian Corporations Act 2001 has two alternative tests for determining when information is generally available:

- **Publishable information**: information that "has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information" (s1042C (1)(b) of the Corporations Act 2001).

- **Readily observable matter**: information is generally available if it consists of readily observable matter (s1042C (1)(a) of the Corporations Act 2001).

146. Informed and uninformed persons can trade at any time on the basis of readily observable matter and no dissemination period is necessary. Whereas uninformed and informed persons are treated differently under the publishable information test. Uninformed persons (i.e. persons who become aware of the information solely as a result of information being made known that would or would be likely to bring it to the attention of persons who commonly invest in securities) can trade immediately as they become aware of the information. But informed persons (e.g. directors, employees etc) who get information from a different means than uninformed persons can trade only after a reasonable dissemination period has elapsed.

147. The requirement that a reasonable time for dissemination has to have passed is intended to prevent an insider, who is aware of the information prior to its release, from getting an unfair start (or advantage) over other market participants. It is not intended to require an embargo on trading for such duration that it constitutes an impediment to the efficient operation of the market. The insider who readily observes the inside information is not subject to this restriction presumably because the

information is readily observable to any market participant who chose to look, and thus any advantage gained by the first person to observe is not unfair.

148. A reasonable dissemination period is not defined in the legislation but the Explanatory Memorandum recommended that the given circumstances of each case should be taken into account when deciding whether the time involved is reasonable. This is probably sensible as the time taken for the information to disseminate will depend on the process used to disseminate the information.

149. A number of problems have been identified with the Australian two-pronged test.

150. In relation to the publishable information test the Explanatory Memorandum states that "it would not be sufficient for information to be released to a small sector of the investors who commonly invest in securities … [the] information must be known to a cross section of the investors who commonly invest in securities."

151. However, the Australian Corporations Act 2001 does not elaborate upon or provide guidelines as to how information should be "made known in a manner that would be likely to bring it to the attention of persons who commonly invest in such securities."

152. The phrase "readily observable" was not originally defined in the legislation, but was added later when concern was expressed that the publishable information test excluded information that was directly observable in the public area as it had not been "made known." It was considered that a person could be liable where they traded in securities on the basis of, for example, an observation that the body corporate had excess stocks in the yard.[26]

153. The Court of Appeal in *Regina v Firns*[27] discussed the problems with the readily observable matter test and indicated that the test seemed to raise more questions than it answered such as:

- To whom must the matter be readily observable- should it be readily observable by the public or people that commonly invest in securities, or is it sufficient that it is readily observable only to the observer;
- By what means observable;
- Observable to whom;
- Where observable.[28]

154. The Court also concluded that as currently drafted, the statute contains conflicting goals embedded in the essentially two-pronged definition of "information

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[26] Explanatory Memorandum to the Corporations Legislation Amendment Bill 1991, para 326.

[27] *Regina v Firns* [2001] NSWCCA 191.

[28] Ibid.

generally available." The publishable test reflects market fairness principles while the readily observable matter test reflects a market efficiency view. This was seen as representing two conflicting goals.

155. The Australian Companies and Securities Advisory Committee identified a number of ways to remedy the problems with the two-pronged definition in its recently released discussion paper. These include:

- **Giving priority to the publishable information test**: by confining the readily observable test to anything not capable of falling within the punishable information test;

- **Clarifying the application of the publishable information test**: the test should be amended to state that the "made known" requirement covers any information, matter or event whose existence or price sensitive implications will, or will be likely to, come to the attention of the investing public either of itself or through some other means. The revised "made known" requirement should also cover any price-sensitive information that would or would likely to come to the attention of the investing public but for a lawful exemption from disclosure. A catastrophe, as well as a court judgement, would be publishable information;

- **Extending the circumstances where a reasonable dissemination period is required under that test**: the test should be extended beyond informed persons to any "connected" with a company to include: any directive or executive office of the company or related company and any other person whose relationship with the company may reasonable be expected to provide that person with access to any undisclosed price-sensitive information about that company. Connected persons who became aware of any publishable information affecting any securities of their companies would be subject to the trading, disclosing, procuring prohibitions in relation to securities until a reasonable period for dissemination of that information has elapsed?; and

- **Reviewing the meaning of the readily observable matter test**: clarify the test to answer questions like observable to whom, how observable and where observable.[29]

156. The United Kingdom and South African provisions have concepts similar to readily observable matter. Information may, but not necessarily will, be regarded as public "even though… it can be acquired only by observation."[30] The United Kingdom civil insider trading provisions also provide that information is treated as generally available if it can be obtained by such means as observation.[31] The draft Singapore legislation proposes to adopt a readily observable matter test based on the current Australian provisions, while by contrast the Malaysian definition of generally

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[29] Companies and Securities Advisory Committee *Insider Trading Discussion Paper,* 2.1-2.50.

[30] United Kingdom Criminal Justice Act s58(3)(c), South African Insider Trading Act 1998 s3(2)(a).

[31] The Financial Services and Markets Act 2000 s118 (7).

available, which broadly follows the Australian definition does not include “readily observable matter."

Questions for Submission

10. How should the test for publicly or generally available information be formulated?

11. Should company insiders be preventing from trading until a reasonable dissemination period has passed?

Research and Analysis

157. Any insider trading regime must seek a balance between prohibiting harmful behaviour and stifling research and analysis that can have a positive impact on the market.

158. Research and analysis on securities by analysts results in a greater amount of information being reflected in the market price of securities. Many people believe, therefore, that investment analysts and professional investors should be permitted to analyse publicly available information and trade on it, in the interests of the efficient operation of the market.

159. In order to protect information and analysis some international insider trading regimes provide exceptions and defences for this kind of activity.

160. While the Australian rationales and information only approach catch a broader net of potential defendants they seek to strike a balance between prohibiting harmful behaviour and stifling research and analysis by providing an exception in the definition of information. The third prong of the Australian “generally available” test states that information is generally available if it consists of deductions, conclusions or inferences drawn from readily observable matter or information made known in a manner likely to bring it to the attention of persons who commonly invest in such securities.

161. However, any deductions gathered from non-generally available information, for example, discussions with company officers about particular matters concerning the company, or analysis of unpublished corporate documents, do not come within the statutory research and analysis exception and may constitute inside information if material and price sensitive.

162. This defence is consistent with the Australian insider trading policy rationale of market fairness and efficiency. It recognises that an investor who obtains information through research and analysis is entitled to take advantage of the information since

other investors in the market could have obtained that information given equal effort.[32]

163. While trading in affected securities by an entity prior to publication of its price sensitive recommendations constitutes insider trading in Australia where entities have an effective chinese wall between research and trading personnel of the entity they can still trade.

164. The German legislation also provides an exemption for research and analysis only if it is based entirely on publicly known information. The United Kingdom and South African statutes provide that information may be treated as having been made public (and therefore not being inside information) even though it can be acquired only by persons exercising due diligence or expertise or by observation. There is no express requirement that the diligence or expertise must be exercised only on publicly available information, though it may be illogical to characterise information gleaned by a researcher from confidential sources as having been made public.

165. By contrast in the United States decision of *Dirks v SEC* the Court held that an analyst who privately questioned corporate employees about rumours of possible fraudulent activities in the company, and then discussed his findings with some clients who subsequently sold their securities in that company, did not breach the United States insider trading rules. The Court held that the analyst had obtained material non-public information from diligent research. To prohibit this activity through the insider trading laws:

> "could have an inhibiting influence on the role of market analysts, which the SEC itself recognises is necessary to the preservation of a healthy market. It is common place for analysts to 'ferret out' and analyse information… and this is often done by meetings with and questioning of others who are insiders."[33]

166. A further issue in relation to research and analysis is whether people may conduct research into particular securities and seek to trade on those securities before publishing their research findings either generally or to their clients. The argument permitting authors of research reports to trade prior to publication of those reports is that research and analysis benefit financial markets. A prohibition on pre-publication trading may reduce the incentive for research.

167. The argument to the contrary is that any trading exemption could result in persons profiting through advance dealings in securities whose price is likely to be influenced by publication of their research findings and recommendations. This may undermine confidence that the market is not open to manipulation.

168. If a chinese wall exception is implemented, it would not prevent corporate entities and partnerships from trading where there is an effective chinese wall

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[32] V. Brudney "Insiders, Outsiders and Informational Advantages under the Federal Securities Laws," *Harvard Law Review* 93 (1979): 341-42.

[33] 463 US 464, 662.

between their research and trading divisions. In the absence of a chinese wall there would be two options:

- “To trade on the basis of the conclusions reached in their research, but not publish their report (that is for internal trading purposes only); and/or
- "To delay trading until the research report has become generally or publicly available.

169. "In the latter circumstance, the publisher can be recompensed by selling its recommendations either generally or to its clients."[34]

Questions for Submissions

12. What should be the exceptions for research and analysis? Should a definition of inside information exclude information gained through research and analysis based on generally available information?

13. Should a person be permitted to trade before publishing their own research?

Materiality of Information

170. All insider trading regimes contain a requirement that the information must be “material."

171. Many of the tests used to determine materiality have arisen from American case law. The United States Courts have used three possible tests for determining materiality. These include the “reasonable investor”, “probability/magnitude”, and “market impact”[35] tests.

172. The reasonable investor test states that for information to be material it must be information of a kind that would affect the decision of a reasonable investor as to whether to retain or to trade securities.

173. The probability/magnitude test concerns events that do not always take place but which have a potential to impact on the market place if they did eventuate. Preliminary discussions or information about such events are taken to be material. In *Wilson v Great American*[36] the court noted that information relating to a future event could be material, if there was sufficient likelihood that such an event would take place.

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[34] Companies and Securities Advisory Committee *Insider Trading Discussion Paper*, 2.84

[35] Mitchell and Netter *The Role of Financial Economics in Securities Fraud Cases: Applications of the Securities and Exchange Commission*, (1994), 548.

[36] 855 F 2d 987 (2d Cir 1988).

174. Many United States Courts have utilised a combination of these two tests. For example in *TSC Industries Inc v Northway Inc,*[37] the United States Supreme Court held that information will be material:

> "…if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding [how to exercise voting rights attached to its shares]… Put another way, there must be a substantial likelihood that the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of the information available."

175. The third test defines materiality in terms of whether the relevant information, if released, would have had an impact on the price of affected securities. The market impact test on its own has not been "a necessary condition for substantiating materiality."[38] Stock prices are used as evidence to demonstrate materiality in market manipulation and insider trading cases. The American courts have accepted that such evidence may be rebutted by evidence that the alteration in the market price resulted from other factors, such as the release of other information or price movements in the market generally.

176. Under the Securities Amendment Act 1988 it has to be established that the information "would or would be likely to, materially affect the price of securities."

177. The Court of Appeal in Wilson Neill also indicated that whether or not information is "price material" is to be objectively determined. Accordingly, the view of the recipient as to the materiality of the price is irrelevant. Secondly the Court was prepared to combine information in order to consider whether the information would have a material impact on the market price.[39]

178. It would appear, therefore, that in New Zealand a combination of the market impact and probability tests are used to determine materiality, and not the reasonable investor test.[40] The type of information that the Court has relied on to determine whether the information will have a material affect on the price comes from either empirical studies of stock prices or the views of market participants (e.g. stockbrokers and accountants).

179. Under the Australian law the test of whether information was material is whether a reasonable person would expect non-public information to have a material effect on the price or value of securities if the information was generally available and the person knows or ought reasonably to know that the information is not generally

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[37] 426 US 438, 449.

[38] Mitchell and Netter *The Role of Financial Economics in Securities Fraud Cases: Applications of the Securities and Exchange Commission*, 549.

[39] *Re Bank of New Zealand; Kincaid v Capital Market Equities Ltd (no. 2)* (1995) 7 NZCLC 260,718 at 260,279.

[40] Although the reasonable investor test was used in *Coleman v Myers* both the Court in *Wilson Neill* and in *Kincaid (no 2)* used the market impact test, rather then referring to the *Coleman v Myers* reasonable investor test when determining materiality.

available and that, if it were generally available, it might have a material effect on the price or value of those securities."[41]

180. A reasonable person would be taken to expect information to have a material effect on the price or value of securities of a body corporate if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell the first-mentioned securities.[42]

181. The Australian materiality test utilises a combination of the United States tests. The reasonable investor test is the focus of the test as the fundamental issue is the influence of information on investor decision-making. It seems that information will be material, under the test, if it would impact on the decision-making of persons who commonly invest in securities taken together with other information available in the market to such investors.

182. One commentator has indicated that the class of persons who commonly invest in securities:

> "comprises largely institutional investors, licensed dealers and professional investors (in the sense of those who carry on a business of investing in the market), who may be taken to act rationally in determining whether information is sufficiently significant to impact on trading decisions. The emphasis in s1002C on whether information would, or would be likely to, influence people who commonly invest in securities in deciding whether or not to deal in them can be justified on the basis that trading by institutional and professional traders is a significant source of movements in the price at which securities are traded on-market."[43]

183. The reference to "material effect on the price or value of securities" also suggests elements of the market impact test:

> "The question of whether information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, buy or sell such securities will be a question for the Court.[44] In leading evidence as to that question, the prosecution may rely on an alteration in the market price of the securities following the announcement of the information to the market, since the efficient market hypothesis suggests that such an alteration may reflect trading decisions made by investors in response to that information."[45]

184. The standard of proof or likelihood of the Australian materiality test is also different from the New Zealand test.

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[41] Section 1043A of the Corporations Act 2001.

[42] Section 1042D of the Corporations Act 2001.

[43] Ashley Black, "The Reform of Insider Trading Law," *UNSW Law Journal* 15, no. 1.

[44] A.J. Black "Policies in the Regulation of Insider Trading and the Scope of Section 28 of the Securities Industry Code", *MUKR* 16 (1986): 651.

[45] Ibid., 229.

185. The Court of Appeal in Wilson Neill held that "likely" in relation to materiality of information means "a real or substantial risk" and rejected the idea that a possibility, however remote, could be included within the term likely.[46]

186. However, "would be likely" in the Australian context means that there is a "probability" that the investment decision of such investors will be affected by the information. If the prosecution can prove there is a probability that the inside information would affect the decision of active investors in such securities then the "reasonable person would expect it to have a material affect on the price or value of securities" the test will be satisfied. Routinely in Australia, expert evidence will be required to prove this. The Australian test contrasts with the Wilson Neill test, therefore, which stated that "likely" means "a real or substantial risk" and that it could not be a possibility.

Questions for Submissions

14. What should the test be for materiality of information? Should the test include the reasonable investor and/or market impact and/or probability elements? What should the standard of proof be?

Application of the Insider Trading Laws

187. The application of insider trading laws is closely linked to the rationales behind the law. For example, people may argue that if you accept the market efficiency rationale the insider trading regime should be confined to those entities listed on a public market. While if the market fairness rationale were adopted then it could apply to a wider range of products and people. Discussion about which financial products and which entities any insider trading legislation should cover are discussed in Part I of the discussion document entitled *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and the Application of Securities Trading Law*.

Prohibitions

188. Under the Securities Amendment Act 1988 and many other overseas insider trading regimes, insiders are usually prohibited from:

- Trading: buying or selling securities;
- Communicating or disclosing information; and
- Procuring (tipping) others to trade on the information.

[46] *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 161.

Trading, Buying and Selling of Securities

189. The Securities Amendment Act 1988 imposes liability on an insider of a public issuer who has inside information about the public issuer and who either buys or sells securities of the public issuer unless permitted under a statutory exemption. Liability is imposed for active trading, and not for failing or refusing to trade.

190. Liability is imposed for active trading, and not for failing or refusing to trade.

191. Section 2 of the Securities Amendment Act 1988 defines “sell” as “including dispose of, agree to sell or dispose of." It defines “buy” as including “purchase, and acquire, and agree to buy, purchase or acquire." Options over existing securities are also included in the extended definition of section 4 of the Securities Amendment Act 1988.

192. Under section 1043A of the Australian Corporations Act 2001 an insider must not, whether as principal or agent, apply for, acquire, or dispose of, relevant Division 3 financial products, or enter into an agreement to apply for, acquire, or dispose of, relevant Division 3 financial products.

193. Like the New Zealand prohibition an insider may lawfully use inside information for the purpose of refraining from trading or cancelling an order to trade, given that the prohibition only applies to active trading.

Issue of New Securities

194. The insider trading provisions in Part I of the Securities Amendment Act 1988 apply to the acquisition and disposition of existing securities. However, it is arguable that the provisions do not apply to the issue of new securities or to contracts to issue new securities, for example the issue by a company of options to acquire new shares.

195. This argument is based on the use of the words "*buy*" and "*sell*" in the Act. "*Buy*" is defined in section 2 to include purchase, acquire and agree to buy, purchase or acquire. "*Sell*" is defined in section 2 to include dispositions and agreements to sell or dispose of. While the meaning of the word "*acquire*" could be wide enough to include acquiring securities as a result of a subscription, it is arguable that without the inclusion of the term "*subscription*", a subscription is not included. Historically in company law, a clear distinction has been made between purchases and subscriptions, and there has been case law to the effect that words such as "*purchase*" do not include subscriptions where the word "*subscription*" has not also been used.[47]

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[47] For example, a reference to "subscription" was added to section 62 of the Companies Act 1955 so that the prohibition against providing financial assistance in connection with a purchase of shares would extend to the provision of financial assistance in connection with a subscription. This was added following the decision in *Re VGM Holdings Ltd* [1942] CH235 where it was held that reference to a purchase of shares did not include an initial subscription for shares.

196. The Securities Commission's report of 1987 which preceded the Act, proposed that the prohibitions apply to sales and purchases. It did not suggest that the prohibitions apply to securities to be issued.

197. There is also some discussion over whether Australian insider trading law does or should cover new securities in the recent Companies and Securities Advisory Committee discussion paper.[48]

198. New securities issues are an important means for companies to expand their financial base and ensure an appropriate equity/debt ratio and insider trading prohibitions should not provide inappropriate obstacles. However, subscribers also need protection against the possibility of a company issuing new securities without disclosing negative inside information.

199. If the insider trading law is to apply to the issue of new securities, then, it will overlap the requirements of the Securities Act 1978 which require disclosure in relation to offers to the public of new securities for subscription. In the case of companies, it will also overlap with the requirements of sections 47 and 49 of the Companies Act 1993.

200. It could be argued that the requirements of the Securities Act 1978 are adequate to protect subscribers for securities from "*insider trading*" by an issuer on the issue of new securities. This is done by the securities regulations requiring a registered prospectus to contain "*particulars of any material matters relating to the offer of securities*."[49] An investor would need to prove that liability arose under section 56 of the Securities Act which provides that certain persons are liable to pay compensation to those who subscribe for securities on "*the faith of an advertisement or registered prospectus which contains any untrue statement for the loss or damage they may have sustained by reason of such untrue statement*." Under section 55(a) of the Act a statement included in an advertisement or registered prospectus is deemed to be untrue if it is misleading by reason of the omission of a particular which is material to the statement in the form and context in which it is included.

201. Under section 58 of the Securities Act 1978 it is also a criminal offence to distribute a prospectus or advertisement that contains an untrue statement. Section 59 of the Securities Act 1978 contains an offence for offering, distributing, or allotting in contravention of the Act.

202. Finally, a person would also have a remedy under section 9 of the Fair trading Act which states that no person shall, in trade, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.

203. There is also some uncertainty surrounding the issue of whether the prohibitions in Part I of the Securities Amendment Act 1988 apply to options over new securities.

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[48] Companies and Securities Advisory Committee *Insider Trading Discussion Paper*, 2.99-2.107.

[49] Clause 40 first schedule, clause 34 second schedule, clause 18 schedule 3A, clause 36 schedule 3, clause 14 schedule 3B, clause 14 schedule 3C, Securities Regulations 1983.

204. It could be argued that these may not be "*securities*" within the meaning of section 2 because they confer only a contractual right to be issued a new security. The definition of "security" in the Securities Amendment Act 1988 requires there to be an "interest or right to participate in any capital…." Until issue of a share, there is no interest or right. The extension of the meaning in section 4 applies only to "securities" as defined. By contrast the definition of "equity security" in section 2 of the Securities Act 1978 applies where there is an "interest or right to a share in the "capital" of a company. This could include a contractual right under an option to be issued a new share.

205. It may be desirable to remove any doubt that the insider trading law applies to transfer of options to acquire new securities. This is because options can be traded in the way that any issued security can. Options over new securities have from time to time been quoted on the New Zealand Stock Exchange. Where such options are tradable, there is good argument that the insider trading law should apply to them.

206. If liability under the insider trading prohibition is to extend to subscriptions for new securities, then the prohibition may apply both to the issuer and to the subscriber. If it is considered that the issuer is the ultimate insider in relation to its own securities, then it may be unlikely that a subscriber will have a greater amount of information than the issuer. However, it may be possible for a subscriber to have inside information unknown to the issuer, for example, where a company is issuing securities to a director or some other person who has particular information by reason of their position.

Intermediaries, Principals and Agents

207. Current New Zealand law does not differentiate between, or deal specifically with, buying or selling as an agent or principal. A person who "buys" or "sells" as an agent would be caught if they were an insider with inside information.

208. Most jurisdictions prohibit primary and secondary insiders holding inside information from buying or selling securities either as a principal or as an agent for someone else.

209. The Australian definition covers principal or agents so that it makes no difference whether they are transacting on their own or someone else's behalf or whether the affected securities are transferred to someone other than the insider.

210. The United Kingdom and South African statutes provide a defence to persons who can show that they would have acted in the same manner even without the inside information.[50] This defence could apply to a person, who, on the basis of research and analysis of publicly available information, decides to buy or sell certain securities, and subsequently, but prior to trading, obtains information that supports that previously reached decision.

211. This would allow persons to structure securities trading plans and strategies, to be implemented at a future time, provided those persons had devised the plan before

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[50] United Kingdom Criminal Justice Act s 53(1)(c), South African Insider Trading Act 1988 s4(1)(b).

they became aware of any relevant price-sensitive information and they had no discretion over the plan or strategy thereafter.

212. Persons with inside information may attempt to avoid prohibitions by trading through intermediaries.

213. Under the United Kingdom and South African provisions, an insider is not guilty of insider dealing by virtue of dealing in securities if the insider shows that he or she would have acted in the same manner even without the inside information.[51] This defence could be raised by persons who became insiders only after giving instructions to their brokers and thereafter did not alter those instructions.

214. One United States commentator argued that persons in these circumstances should be required to cancel the trade, unless this involves a penalty:

> "So long as the ability to cancel without liability is present, a decision not to cancel is, in effect, an investment decision."[52]

215. Subsequently, however, SEC Rule 10b5-1 introduced a specific affirmative defence to a breach of the insider trading provisions that, "before becoming aware of the information, the person had instructed another person to purchase or sell the security for the instructing person's account." That exclusion only applies to instructions given in good faith and not as part of a plan or scheme to evade the insider trading prohibition.

216. There are at least three options for determining the time when insiders who act through a broker or other market intermediary incur liability:

- **When an insider with inside information gives instructions to a broker**: A client who at that time was not aware of inside information would not breach the legislation, even where the client subsequently became aware of any inside information. In this respect, this result would reflect the approach in SEC Rule 10b5-1;

- **When an offer is placed on a stock exchange trading system**: A client who received inside information in the period between instructing the broker and the offer being *placed* would be obliged to take all reasonable steps to withdraw the offer to avoid breaching the legislation. This would reflect the Australian pre-1991 provision which provided that an insider "shall not deal in relevant securities", with the term "deal" including making an offer; and

- **When the offer is accepted by another exchange trader**: A client who received inside information in the period between instructing the broker and the offer being *accepted* would be obliged to take all reasonable steps to withdraw the offer to avoid breaching the legislation.

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[51] Criminal Justice Act 1993 s 53(1)(c), South African Insider Trading Act 1998 s 4(1)(b).

[52] D. Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* (West Group) (looseleaf) §3.04 at 3-28.

217. The first or second policy option could have unusual results. A person could be liable for insider trading, even where no trading took place (for instance where the instructions were not carried out or were withdrawn, or an offer placed on the trading system was subsequently withdrawn or not matched).

218. The third policy option would avoid this problem and apply the insider trading provisions when on-market contracts are made. However, as noted above, this policy option would require a person who became aware of inside information after instructing a broker to act diligently to withdraw any affected offer that had not been accepted.

219. Under Australian law a person working within the office of a broker or other intermediary may lawfully carry out the instructions of a client, even where the office holds relevant inside information, provided that the person acts under specific instructions from the client and the person was not aware, and there were arrangements to ensure that he or she could not be aware, of the inside information.[53] However, this provision is not designed to deal with the situation where the inside information comes from the client.

220. In New Zealand the person will only be liable if told information by a primary or secondary insider (if they are not more than two removes from a primary insider).

221. The South African legislation deals directly with this matter. It provides that an intermediary trading for a client is not guilty of an offence if the intermediary proves on a balance of probabilities that he or she:

> "was acting on specific instructions from a client, *save where the inside information was disclosed to him or her by that client*."[54] [emphasis added]

222. This makes it clear that an intermediary cannot lawfully transact in particular securities on the instructions of a client who has given the intermediary inside information regarding those securities.

223. The United Kingdom Financial Services Authority Code of Market Conduct provides that intermediaries will be civilly liable for market abuse (including insider trading) in executing the instructions of their clients only if they knew or ought to have known that their clients were themselves engaging in market abuse when the intermediaries executed the clients' transactions.[55] Where these elements are satisfied, there is no requirement that the inside information be disclosed to the intermediary.

224. The South African and United Kingdom principles seek to provide clear guidance to practitioners. An intermediary who has knowingly received inside information from a client, or has merely been informed by the client that the client

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[53] Section 1043K of the Corporations Act 2001. In addition, ASX Business Rule 3.5 deals with chinese walls for brokers.

[54] South African Insider Trading Act 1998 s 4(1)(a).

[55] FSA Code of Market Conduct April 2001, para 10.3.

holds inside information, should be prohibited from transacting in affected securities for that client.

225. An intermediary who has been informed by a client of inside information, or that the client has inside information, should be entitled to transact for other, uninformed, clients in affected securities only on an "execution-only" basis.

Questions for Submissions

15. How should trading be defined?

16. Should trading cover the issue of and subscription for new securities and the transfer of options to subscribe for new securities?

17. Should trading cover principals and agents?

18. Should there be any defences to prohibited trading?

19. Should persons with confidential price-sensitive information be liable when they instruct a broker to trade, when the broker places the offer on the market or when the offer is accepted by a counterparty broker?

Disclosing Inside Information

226. Under section 9(1)(b) of the Securities Amendment Act 1988 an insider of a public issuer is liable for insider trading if they:

- have inside information about the public issuer; and
- communicate the information, or cause the information to be disclosed; and
- know or believe that person or another person will, or is likely to
  - buy or sell securities of the public issuer; or
  - advise or encourage another person to buy or sell securities of the public issuer.

227. This section requires communication of the information but does not require communication in confidence.

228. Under Australian law any person who is aware of inside information is prohibited from directly, or indirectly, disclosing confidential price sensitive information concerning Division 3 financial products that are able to be traded on a financial market to another person who they know, or ought reasonably to know, would transact in the securities or procure some other person to transact. There are various statutory exceptions for certain disclosures, for example disclosures to underwriters and disclosures pursuant to legal requirement.

229. Under both the New Zealand and Australian regimes the disclosure prohibition only applies where there is an actual or reasonable expectation that the recipient (or some other person) will transact in the affected securities. A person who *discloses* inside information for the clear purpose of discouraging persons from trading would fall outside the prohibition.

230. Most international jurisdictions prohibit primary or secondary insiders from disclosing inside information to another person. Under United States law primary and secondary insiders are liable for disclosing inside information to recipients only where that disclosure breaches a fiduciary or like duty owed by the disclosing person and the disclosure is made for that person's direct or indirect personal benefit. However, in the takeover context, these restrictions do not apply. Any person (other than the bidder) is liable for disclosing inside information where it is reasonably foreseeable that the recipient will trade. There is an exception for any communications made in good faith to the officers, directors, agents, advisers or employees of the bidder or target company in connection with conducting the bid.

231. Some jurisdictions provide insiders with defences to disclosing information where:

- The disclosure took place in the proper performance of the functions of the primary or secondary insider's employment, office or profession. In South Africa, however, it must also be established that the insider, at the same time, disclosed that the information was inside information (thereby putting the recipient on notice). Also, the United Kingdom civil regime, except in certain instances (for instance, disclosures to employees or professional advisers to enable them to perform their functions), requires that any lawful disclosure of inside information should be accompanied by a statement indicating that the information is inside information and that the recipient should not trade until after the information has been made generally available;

- Some countries provide a defence where the insider did not expect the recipient (or any other person) to trade because of the disclosure.[56] This defence would, for instance, protect insiders who confide confidential information to another person, not as part of the proper performance of their official functions, but for reasons unrelated to trading in those securities; and

- The United Kingdom also provides a defence if the insider can show that, although he or she expected that the recipient would trade, the insider did not expect that any such trading would result in a profit, or avoidance of a loss, attributable to the inside information.

232. Germany makes it an element of the offence that the disclosure must have taken place without the requisite authority. Otherwise, that jurisdiction has no statutory defences to the disclosure prohibition.

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[56] United Kingdom, South Africa, New Zealand. The South African defence requires that the insider's belief be reasonable. New Zealand imposes civil liability for disclosure only if the person disclosing knows or believes that the recipient person will buy or sell affected securities or that the recipient will advise or encourage a third person to buy or sell those securities.

233. The United States law effectively does not prohibit disclosures for the purpose of non-trading. The United Kingdom and some other jurisdictions also, in effect, do not prohibit insiders from disclosing inside information where those insiders intend to discourage the recipient from trading.[57] By contrast, primary insiders under the German legislation are liable for disclosing inside information without authority, whether or not they intend or suspect that the recipient would trade in the relevant securities, or whether the recipient does in fact trade. However, it appears that secondary insiders are only liable under German law for unlawfully disclosing inside information if the recipient in fact trades.

Questions for Submissions

20. What elements should be included in the disclosure prohibition?

21. Should insiders be prohibited from disclosing inside information without lawful reason (for instance, in the proper performance of the person's employment, office or profession), even where the purpose or result of the disclosure is that the recipient does not trade?

22. Should a person lawfully disclosing inside information be required to inform the recipient that the information is inside information?

Procuring Trading/Tipping

234. Under section 9(1)(a) of the Securities Amendment Act 1988 an insider of a public issuer is liable under the Act if they:

- have inside information about the public issuer; and
- advise or encourage any person to buy or sell securities of the public issuer; or
- advise or encourage any person to advise or encourage any other person to buy or sell securities of the public issuer.

235. The Court in *Wilson Neill* considered that under the provision it is not necessary to disclose the information, but merely to advise or encourage the purchase or sale of securities.

236. The Court also held that absence of moral fault had no bearing on liability under section 7 or 9. An insider will be liable for tipping under section 9 irrespective of whether or not the insider realised he or she possessed the inside information or the significance of the information. Thus an insider whom the Court assesses to have possessed the information will be liable for tipping if they advise or encourage trading by another person, or disclose information without realising its significance.

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[57] United Kingdom, South Africa, New Zealand have the defence that the insider did not expect the recipient (or any other person) to trade because of the disclosure.

237. An insider will be liable, even if they believed the tippee would not trade, if they advised the tippee to advise another party to trade or knew or believed that the communication would or would be likely to lead to a tippee advising or encouraging a third party to trade.

238. Under the Australian insider trading regime insiders are liable for procuring another person to trade in affected securities, unless a statutory exemption or defence applies. The expression "procure" is widely defined to include inciting, inducing or encouraging an act or omission by another person.

239. The Australian tipping provision does not require any association or connection between the tipper and the tippee. An insider who possesses objectively price sensitive inside information relating to securities which the insider knows or ought reasonably to know is materially price sensitive inside information, cannot communicate that information to any person if the insider knows or ought reasonably to know that other person (the tippee) would or would be likely to deal in securities or procure another to do so.

240. The insider need not disclose the inside information to the person procured, or even indicate that the insider is aware of any price-sensitive information. In addition, it is not necessary to establish that the person who is procured actually transacted in the securities, mere encouragement to do so may suffice. Likewise, the motivation for procuring is irrelevant.

241. An insider may lawfully use inside information for the purpose of procuring another person not to trade or to cancel an order to trade, given that the procuring prohibition only applies where transactions take place.

242. Most international jurisdictions prohibit primary or secondary insiders from:

- procuring another person to buy or sell affected securities; or
- encouraging or recommending another person to deal in affected securities, where they know, or have "reasonable cause to believe", that the other person will so deal (even if dealing does not actually take place).[58]

243. Under United States law, primary and secondary insiders are liable for recommending or encouraging trading by a recipient only where there is a breach of the same fiduciary duty and direct or indirect personal benefit prerequisites that apply to disclosing inside information.

244. The United Kingdom and South Africa provide insiders with a defence to procuring or encouraging trading where the insiders prove that they would have done what they did even if they had not had the information (see q18 and para 210).

245. The United Kingdom also provides a defence if insiders:

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[58] United Kingdom, Germany and South Africa. The German insider trading legislation does not deal directly with secondary insiders procuring, encouraging or recommending. However, German law probably has this prohibition on secondary insiders by virtue of its aiding and abetting offences.

- did not at the time expect the dealing to result in a profit or avoidance of a loss attributable to the inside information; or
- believed on reasonable grounds that the information had been disclosed widely enough to avoid any participant in the dealing being prejudiced by not having the information.

246. Most of the jurisdictions do not prohibit insiders from procuring other persons not to trade in affected securities. However, South Africa imposes liability on any insider who either "encourages or causes another person to deal or discourages or stops another person from dealing" in the affected securities.

Questions for Submissions

23. How should the prohibition against encouraging/advising/procuring be formulated?

24. Should liability be imposed on insiders if, on the basis of the inside information, they "discourage or stop" another person from dealing in affected securities?

Knowledge and Possession

247. When an insider is deemed to possess information and whether the insider needs to know that the information they possess is inside information is dependent to a degree on the rationales behind an insider trading regime and the penalties involved.

248. All that is required for liability to arise under section 7 of the Securities Amendment Act 1988 is that the insider possessed the information at the time of trading, not that the insider used or was influenced by the inside information. The absence of moral fault also has no bearing on liability under section 7 or section 9.[59] An insider would be liable irrespective of whether the insider realised that they possessed the inside information or the significance of the information.[60]

249. The fact that the New Zealand regime requires only that an insider possess inside information, and not that they know the information is inside information is a reflection of the fact our regime only has civil penalties. As our regime is based on the fiduciary duty rationale and has civil penalties what is important is that the insider possessed the information and that there was a breach of the fiduciary duty.

250. The Court held in *Wilson Neill* that it was not necessary that a person had analysed the material in order to possess it or that a person was aware of the importance of the information:

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[59] *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2NZLR 152, 162.

[60] Ibid., 162.

> "We do not accept the argument presented for Magnum by Mr Lattimour that the nominee directors did not possess information because they had not done, or were not proved to have done, an analysis of material in the compendious board papers furnished to them from which the information could be inferred. The test is not subjective knowledge, but the objective possession of the information. Otherwise the purpose of the legislation could be thwarted by difficulties of proof."[61]

251. It is up to the Court to determine whether the inside information could be "inferred" from the information or documentation that was in the possession of the insider.

252. Under the Australian legislation, the prosecution must prove that a defendant:

- Was aware of (possessed) the relevant information at the time of trading or procuring (awareness test); and
- Knew (subjective knowledge test) or ought reasonably to have known (objective knowledge test) that this information was not generally available and was materially price sensitive.

253. These awareness and knowledge tests are consistent with the recommendations in the Griffiths Report and the market fairness and efficiency rationales that require knowledge of the wrong, rather than simply the breach of a duty. Further, they reflect the fact that the Australian regime has criminal penalties.

254. Under the Australian test even if a person possesses inside information which is materially price-sensitive in an objective sense, that person will not be liable for insider trading if the prosecution is unable to prove beyond reasonable doubt that the person knew or ought reasonably to have known that the information is inside information and the information is materially price sensitive.

255. The purpose of this provision is to protect persons who trade while they possess or are deemed to possess information that they could not be reasonably expected to know is materially price-sensitive inside information. For example, this would apply to a situation where a person overhears materially price sensitive inside information but trades for some other reason as they do not know or have no reasonable cause to believe the information is materially price-sensitive inside information.

256. A difficult, but rarely acknowledged aspect of criminalising insider trading by corporations is the problems associated with attributing criminal responsibility to corporations generally. Special considerations apply to determining which acts and purposes of a natural person purportedly acting for and on behalf of a corporation can be taken to be the acts and purposes of the corporation itself for purposes of a criminal prosecution. The Australian Financial Services Reform Act 2001 went some way to dealing with this issue under sections 769B and 1042G.

257. This section deems bodies corporate and partnerships to possess information in certain circumstances. A body corporate or a partner of a partnership cannot breach

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[61] Ibid., 161.

the insider trading prohibitions unless they know or ought reasonably to know that the information that they possess is materially price sensitive inside information. In determining whether they ought reasonably to know, the court will consider the knowledge of a body corporate's directing mind and will and in the case of a partner, taking into account all the circumstances (including the fact that the person is a partner) whether the partner is deemed to possess is materially price sensitive information.[62]

258. These deeming provisions will not apply if the body corporate or partnership proves that a chinese wall prevented the inside information passing from the possessor of the information to the person dealing in the securities.

259. The French Courts have implied into the French criminal insider trading law a presumption of awareness of particular information in limited circumstances. Thus, any persons who were the directors of, or were otherwise involved in, the management of a company and who traded in the securities of that company are deemed to be aware of any inside information that derived from within that company when they conducted the transactions. The defence has the onus of rebutting that presumption of awareness by presenting evidence to the contrary.

260. These rebuttable presumption of awareness tests may assist in insider trading prosecutions against directors and managers of a company, who may be the people most likely to be aware of inside information. However, it does not overcome the evidential difficulties in proving awareness in any prosecutions against third persons who may have received inside information from directors or managers. The mere existence of a relationship between director or manager and a third person would not usually be sufficient to prove that the inside information had been passed on to the third party.

261. While a rebuttable presumption that directors and other connected persons are aware that information they hold is inside information could assist in insider trading prosecutions. It may not generally be appropriate to have presumptions of this nature in criminal proceedings, even against persons closely connected with the source of the inside information. This test for connected persons also tends to fit easier with the fiduciary duty and misappropriation rationales, as it deals with relationships with or connections to the entity.

262. It is not usually an easy task for the prosecution to prove that the defendant knew or ought reasonably to have known that the information was materially price sensitive inside information. It has been argued that it is the defendant who has the most knowledge of the facts and is in the best position to prove they did not know that information was material price sensitive information. For this reason, placing the burden on the prosecution makes it more difficult for the prosecution to prove the case.[63]

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[62] Gordan Walker ed. *Securities Regulation in Australia and New Zealand* (LBC Information Services, 1998), 568.

[63] Ibid., 576.

263. Most other jurisdictions require proof that the person was subjectively aware of particular information.

264. The United Kingdom and South African provisions apply only the subjective knowledge test, that is, that the defendant "knows that it is inside information." There is no equivalent of the objective knowledge test. The difficulties in proving subjective knowledge under United Kingdom law have resulted in the collapse of a number of insider trading prosecutions.[64]

265. The Monetary Authority of Singapore (MAS) proposes that the Australian subjective/objective knowledge tests apply to connected persons, but that only the subjective knowledge test applies to non-connected persons.[65] Liability of directors, other officers and other connected persons, for breach of the insider trading provisions would depend on showing that they knew (subjective knowledge test) or ought reasonably to have known (objective knowledge test) that any information concerning their corporation was not generally available and was materially price sensitive. Connected persons would be presumed to have satisfied these knowledge tests, unless they can prove otherwise on a balance of probabilities. The MAS considers that this approach will introduce greater discipline for those in fiduciary positions.

266. By contrast, liability of non-connected persons would depend on proof of the subjective knowledge test, that is, that they knew that the information in their possession was not generally available and was price sensitive.

267. Obtaining corroborative evidence that a person was in possession of inside information can be the most difficult aspect of insider trading investigations.

If Criminal Liability Is Imposed Should it Require That a Person Holding Inside Information Has Used (Relied on) That Information in Trading?

268. If criminal penalties are imposed for insider trading in New Zealand one issue that may need to be addressed is whether a person holding inside information has used that information in trading.

269. The Corporations Act 2001 does not require the prosecution to show that a person holding inside information used that information when trading in affected securities. The Griffiths Report recommended that the legislation provide that a person shall not use confidential price-sensitive information to trade in securities.[66] However, the Government at the time of introducing the 1991 amendments took the view that, once the prosecution has proved that the person was in possession of the

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[64] M. Stamp and C. Welsh eds. *International Insider Dealing (FT Law and Tax)*, (1996), 101.

[65] Monetary Authority of Singapore, *The Securities and Futures Act 2001 Consultation Document*, (March 2001), 27.

[66] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, *Fair Shares for All: Insider Trading in Australia* (11 October 1990) Recommendation 2.

inside information and traded in the relevant securities, it was reasonable to assume that the person was motivated to trade by possession of that information.[67]

270. Some jurisdictions require the prosecution to prove that the defendant used or took advantage of the inside information.[68] Some other jurisdictions provide a defence where the defendants can prove that they did not use the inside information.[69]

271. The United States and the Canadian provinces have taken a different approach by having various specific defences instead of a use requirement. US SEC Rule 10b5-1 permits persons to structure securities trading plans and strategies, including selective buy-backs, employee share plans or dividend re-investment plans, which may be implemented at any future time, provided that those persons are not aware of material non-public information at the time of devising the plan, entering into a binding contract to purchase or sell securities or instructing an agent to do so and have no discretion over the previously determined trading plan once they become aware of any inside information.

272. A provision similar to SEC Rule 10b5-1 may provide companies and individuals with the flexibility to plan their securities trading at a time when they have no inside information advantage over other market participants. Without some exemption, bona fide market participants may be unable to trade because of information that comes to their attention after they have reached their trading decisions. The evidential onus should rest on persons relying on the Rule to establish that they acted before becoming aware of the inside information

273. On the other hand, it may be very difficult for a prosecutor to disprove a sequence of events put forward in evidence by a defendant. In other circumstances, the reverse onus whereby a defendant must prove lack of use might give market participants some relief where they can establish that their trading is totally unrelated to their possession of inside information. However, an argument against adopting this rule is that it may create the possibility for individuals to erect plausible screens to disguise their real motivation for trading. It may be a simple matter for a trader, with the benefit of hindsight, to suggest numerous reasons for trading other than the possession of inside information.

Trading Contrary to the Inside Information That the Insider Holds

274. The statutory prohibition on trading in New Zealand applies to insiders, regardless of whether that trading is consistent with the likely price impact of the inside information.

275. The United Kingdom legislation provides a defence if the defendant can show “that he did not at the time expect the dealing to result in a profit [or avoidance of a

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[67] Government Response to *Fair Shares for All*, para 29.

[68] Germany, Canadian federal legislation, Singapore (though the draft Singapore legislation abolishes the use requirement).

[69] United Kingdom, South Africa.

loss] attributable to the fact that the information in question was price-sensitive information in relation to the securities."[70] By contrast, the South African legislation, which is largely modelled on the United Kingdom provisions, has not included this defence.

276. There may be an assumption in the commercial community that any trading contrary to inside information is permitted, or at least is not reprehensible, as the insider has not benefited from the transaction. Also, it is highly unlikely that a regulator would take action against a person who clearly traded contrary to inside information. However, there is a risk that the United Kingdom defence could be manipulated by insiders claiming that, despite trading profitably, they did not expect to receive a profit (or avoid a loss) through trading. Also, some confidential inside information may clearly be price-sensitive, without the holder being able to determine whether it will increase or decrease the price of the securities (for instance, the pending resignation of a senior executive or a planned merger). The provision may provide a defence to an insider who traded on what turned out to be an incorrect assumption about the share price impact of the inside information, when later made public.

277. The approach to this issue can also be linked to the rationales for prohibiting insider trading. The fiduciary/misappropriation theories would fit better with a regime that focussed on the use of the information. Conversely, a market effect based approach would imply that a prohibition should not be introduced for behaviour that could have no negative effect on the market.

278. This section on knowledge is relevant to, and should be read in conjunction with, the discussion on an insider trading offence in Part II of the discussion document *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and Application of Securities Trading Law*.

Questions for Submissions

25. What if any knowledge should be required in the insider trading prohibition? (Please bear in mind which penalties you believe should be imposed for insider trading and refer to Part II of *Reform of Securities Trading Law: Volume Three: Penalties, Remedies and Application of Securities Trading Law*)

26. When should a body corporate or partnership be deemed to possess inside information?

27. If criminal liability is imposed should it require that a person holding inside information has used (relied on) that information in trading?

28. Should an insider be permitted to trade contrary to the inside information that he or she holds, that is, by selling [buying] particular securities while holding positive [negative] inside information concerning them?

[70] Criminal Justice Act 1993 s 53(1)(a), (6).

Exceptions and Defences

279. The exceptions and defences required in any insider trading regime will depend on how wide the insider trading prohibition is. For example if only the information connection approach is taken then a wider range of exceptions and defences will need to be implemented. The following situations are explored as possible exceptions and defences to an insider trading regime:

- Buy backs;
- Underwriting;
- Exception for transactions pursuant to a legal requirement or by operation of law;
- Exception for information communicated pursuant to a legal requirement;
- Chinese walls;
- Exception for knowledge of person's, or entity's own intentions or activities;
- Procedures to allow trading by certain insiders;
- Equal information defence; and
- Takeovers.

280. Other possible exceptions and defences have also been discussed throughout this paper.

Buy Backs

281. There is no exception in the Securities Amendment Act 1988 for buy-backs. This means that a company may be liable as an insider to itself and its shareholders, where it purchases shares pursuant to a buy-back.

282. The statutory procedure in the Companies Act 1993 regulating buy-backs contains detailed restrictions on the extent to which the board can hold material price sensitive information that is not disclosed to shareholders when making a buy back offer. For this reason it has been argued that buy backs should be taken outside the ambit of any insider trading provisions.

283. Although the Companies Act requires directors to consider whether there is any undisclosed price sensitive information, the remedy for an aggrieved shareholder would be against the company for unfairly prejudicial conduct. Shareholders could also argue that the directors breached their duty to act in accordance with the Companies Act, but the Act does not specify whether this duty is owed to the company or the shareholders.

284. If the market fairness and efficiency principles are accepted as the rationales behind our insider trading regime then the Companies Act provisions will not

adequately address the harm caused by the insider trading activity. The Companies Act only provides a remedy for a breach of duty owed between companies, directors and shareholders and does not redress the harm caused to the market. Insider trading legislation would provide a more effective remedy and may provide a better deterrent.

285. Even if the fiduciary duty or misappropriation rationales are accepted the insider trading legislation may still provide a more effective and appropriate remedy and provide a better deterrent as the stigma of insider trading activity will be attached, and may result in larger penalties.

Questions for Submissions

29. Should there be an exemption for buy backs in the legislation? If so, what features should it have?

Exception for Underwriters

286. Underwriters and sub-underwriters generally require full disclosure of all material information in order to determine whether or not to underwrite a proposed issue of securities. If they were prevented from obtaining this information they may not be prepared to perform this service.

287. Issuers also may need the freedom to disclose inside information to potential underwriters during negotiations in order to select the underwriter and agree on the terms of the issue.

288. Merchant banks or sharebrokers who underwrite issues may also be acting as professional advisers in marketing the issue. In this role, they are likely to receive confidential price sensitive information.

289. Often an underwriter will seek to share the risk by entering into arrangements with others who will sub-underwrite the issue. These people may be institutional investors. Sub-underwriters may require disclosure of confidential price sensitive information before they will agree to sub-underwrite an issue.

290. Issues of insider trading arise because the issuer may be liable for communicating the inside information to the underwriter. The underwriter may be liable for communicating the information to the sub-underwriters. The underwriters and the sub-underwriters may be liable for subscribing for the securities and for on-selling securities acquired by performing their underwriting obligations. However, it is arguable that an underwriter who subscribes for securities under an agreement to underwrite an offer of new securities for subscription will not be liable under the Securities Amendment Act 1988. This is because arguably Part I of the Act does not apply to the subscription for new securities. (See the discussion in paragraphs 194 – 206).

291. Australian law provides a number of exceptions relating to underwriting.[71] The following are excepted from the insider trading prohibitions:

- subscribing for securities under an underwriting or sub-underwriting agreement;
- entering into an underwriting or sub-underwriting agreement; and
- selling securities subscribed for under an underwriting or sub-underwriting agreement.

292. There are also exceptions from the provisions prohibiting communication of inside information in relation to securities where the communication is solely for the purpose of procuring a person to enter into an underwriting agreement or a sub-underwriting agreement or to subscribe for such securities.

293. Opponents to an underwriting exception argue that allowing an exception for information communicated by underwriters to subscribers of securities "is an invitation to significant abuse as brokers have been shown to be more likely than other industry actors to be very prone to take advantage of inside information."[72]

294. However, the alternative view is that it is in the public interest of the market of offers of securities, that issuers and underwriters be permitted to enter into and perform underwriting and sub-underwriting agreements and to communicate confidential price sensitive information for the purposes of underwriting offers of securities. This is because the process of underwriting assists with the offers of securities and the ability of issuers to raise money.

295. Given the commercial practice of issuers disclosing confidential price sensitive information to underwriters, an exception for underwriters can be justified on the basis that these are transactions between persons with an equal access to information. This is consistent with the introduction of an "equal information" defence. However, it is difficult to justify an exception which would allow a person to use an exception available to an underwriter when on-selling to uninformed counterparties. This behaviour would not be considered appropriate under the market efficiency and fairness rationales by giving underwriters and sub-underwriters an unfair advantage.

Questions for Submissions

30. Should the communication of inside information for the purpose of procuring a person to enter into an underwriting or sub-underwriting agreement be exempted?

31. Should an underwriter or sub-underwriter who has that inside information be

[71] Section 1043C Corporations Act 2001.

[72] R Tomasic "Insider Trading Law Reform in Australia," *Company and Securities Law Journal* 9 (1991): 141.

able to subscribe for securities under the agreement?

32. Should an underwriter be permitted to on-sell securities taken up under an underwriting agreement before inside information given to the underwriter becomes generally available?

Exception for Transactions Pursuant to a Legal Requirement or by Operation of Law

296. Sometimes the buying or selling of securities is required by law. For example where a company is required to acquire the shares of a dissenting shareholder under the provisions of sections 110 to 115 of the Companies Act 1993, or where a dominant owner is required to purchase shares under the compulsory acquisition provisions contained in the Takeovers Code. A requirement to compulsorily acquire securities can also be incorporated into the constitution of an issuer, for example under Notice and Pause provisions contained in the constitution of an issuer listed on the New Zealand Stock Exchange.[73]

297. These procedures contain provisions allowing for the determination by an expert or arbitrator of the price to be paid for the relevant securities. It may not be appropriate for insider trading law to apply in these situations, on the basis that the process should ensure that all price sensitive information is discovered in the process of determining the price and the transaction is required by statute.

298. In other cases, securities may be "acquired" or "disposed of" by operation of law, for example under an amalgamation effected under Part XIII of the Companies Act 1993, or by a compromise, arrangement or amalgamation approved under Part XV of the Companies Act. Note that shareholders that vote against these transactions may have rights to require the company to acquire their shares. These provisions also contain procedures for determining the consideration, and transactions approved under Part XV are also subject to the supervision of the Court. In these situations it may not be appropriate for the insider trading prohibitions to apply.

299. It may be appropriate that the exception only apply where the transaction is, pursuant to a requirement (rather than discretion) imposed upon the person by law. For example it may not extend to an entity which seeks to buy back its shares but is not required to.

Questions for Submissions

33. Should there be an exception for acquisitions required by law under sections 110 to 115 of the Companies Act 1993 and pursuant to the compulsory

[73] Note that with the introduction of the Takeovers Code, the compulsory acquisition provisions included in the constitutions of NZSE listed companies incorporated under the Companies Act 1993 cease to have effect.

acquisition provisions in the Takeovers Code?

34. Should the insider trading prohibitions apply to transactions in securities effected by operation of law, for example under Parts XIII and XV of the Companies Act 1993?

35. Should the exception be applied only where the transaction is pursuant to a requirement imposed on the person by law rather than a discretion given to that person?

Exception for Information Communicated Pursuant to a Legal Requirement

300. The communication of inside information may be necessary pursuant to a requirement imposed by law. For example communications required in accordance with discovery obligations under a legal proceeding may be considered tipping. Without an exception provided in the legislation these people or entities will be considered to breach the insider trading provisions.

Questions for Submissions

36. Should there be an exception for information communicated pursuant to a legal requirement?

Chinese Wall Exceptions

301. Insider trading provisions apply to any person who “possesses” confidential price-sensitive information. Most jurisdictions take a body corporate, partnership, financial intermediaries or their representatives to possess information if it is held by any of their officers in the course of their duties.

302. However, often these entities will not breach the prohibition if internal arrangements (a chinese wall), which satisfies the legislative requirements, exists to ensure that no inside information or related advice is communicated between the person entering the transactions on behalf of the organisation and the person possessing the information.

303. The chinese wall is typically characterised by “policies and procedures governing dissemination of the information and on occasion through physical separation of departments."[74]

304. Some commentators have stated that such policies should be “documented, should involve physical access restrictions and document control procedures

[74] L.E. Herzel and D.E. Colling "The Chinese Wall and Conflict of Interest in Banks" *Business Lawyer* 34 (1974): 88.

including limits on access to sensitive material held in computer files, separate supervision of divisions on opposite side of the chinese wall, except at senior management level, and if possible, limits on transfers between the corporate advisory section and the trading desk of a broking firm."[75] "Those policies should be reinforced by continuing education programmes and by imposing disciplinary sanctions for breaches. It may also be appropriate for the firm to require employees to report their personal trading and to monitor trading by the firm on its own account, to detect any sign of breach of the chinese wall."[76]

305. The effectiveness of chinese walls is controversial. Chinese walls are difficult to establish in a firm with a small number of employees performing common functions. There may be a risk of accidental leakage of information as a result of informal dealings between staff in separated departments, transfer of staff from one department to another or as a result of access to information relating to departments on opposite sides of the chinese wall by executive management of the firm. If a chinese wall operates effectively in a larger firm it may do so only at the cost of preventing the firm from drawing on the expertise of employees and management on the other side of the chinese wall.

306. The difficulty with chinese wall exceptions is that it relies on the integrity of the organisation, which claims to have the chinese wall in place, for its effectiveness. However, it is argued that the chinese wall defence should remain available to those organizations that can effectively quarantine any inside information. Further, if you "set up deliberate systems which are properly explained to people, if you enforce these systems and insist on compliance you can overcome a large number of problems [with the chinese wall provisions]."[77]

307. In particular, problems have been identified with chinese wall exceptions for financial intermediaries that allow dealers to establish a chinese wall between the representative in possession of the inside information and the representative who gives advice to the client.

308. The recent Companies Advisory and Securities Committee report on insider trading raised the question as to whether the principles that underlie the chinese wall defence continue to be relevant for financial intermediary organizations:

> "On one view the distinction between research and trading is becoming increasingly blurred, given modern information transfer technology and the involvement of personnel with specialist knowledge of particular financial instruments in both research and trading. It may be increasingly difficult to erect, or maintain, effective communication or knowledge barriers within an organization."[78]

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[75] D.C. Langevoort *Insider Trading Regulation*, 1991ed, 403,406; C.A. Quinn "The Securities Amendment Act 1988 and the Chinese Wall", *Otago Law Review* 7 (1987): 41.

[76] Ibid., 249.

[77] House of Representatives Sanding Committee on Legal and Constitutional Affairs (Griffiths Committee) *Insider Trading (*AGPS, 1989), para 4.9.4.

[78] Companies and Securities Advisory Committee *Insider Trading Discussion Paper*, para 2.193.

309. The alternative view is that "compelling reasons should be required for denying the availability of a chinese wall defence to securities intermediaries and merchant banks, since the effect of doing so would be to require separation of dealing and corporate advising functions, imposing substantial economic costs and excluding desirable synergies available from sharing research, administrative and other facilities."[79] Further, as stated above it is only fair that the defence should remain available to those organizations that can effectively quarantine any inside information.

Questions for Submissions

37. Should there be a chinese wall exception to the insider trading prohibition? If so, to whom should the exception apply?

Exception for Knowledge of Persons' or Entities' Own Intentions or Activities

310. This exception would allow a natural person or entity (includes officers and agents of the entity) to trade or procure a deal while having knowledge of their own activities or intentions in relation to past or proposed transactions in the securities of the relevant body corporate. This exception will be more relevant if the definition of "inside information" includes externally generated information.

311. This exception would mean that a potential offeror would not breach the insider trading provisions by dealing in the securities of a potential target prior to a takeover offer. However, the exception would only apply to the offeror and would not allow "warehousing" which is the practice of procuring friendly parties to acquire target shares prior to the formal takeover. The exception would not extend to the knowledge that the offeror body corporate has about the intentions of its related companies and such information would be considered inside information.

312. The exception would also apply to a person who sells a small parcel of shares intending to sell a large parcel of shares later on. Such a person will not be engaging in insider trading even though the prior sale of the small parcel of shares was intended to defray a loss to be caused by the sale of the larger parcel of shares.

Questions for Submissions

38. Should there be an exception for knowledge of persons' or entities' own intentions or activities?

[79] Black "Policies in the Regulation of Insider Trading and the Scope of Section 128 of the Securities Industry Code", 662.

Equal Information Defence

313. In Australia insiders have a specific defence to a criminal prosecution if the court is satisfied that the counterparty to the transaction "knew or ought reasonably to have known" of the confidential price-sensitive information[80]. This is known as the "equal information defence." Under the defence a person in possession of price-sensitive information in Australia can avoid criminal prosecution by disclosing that information to the party with whom he or she is transacting.

314. It has been argued that this is a curious defence given the market fairness and efficiency rationale for insider trading in Australia:

> "Why should it be acceptable for an insider to trade with someone (probably a stranger) by merely disclosing the price sensitive information, thereby permitting him and the other party to presumably share, through negotiation, the gains of doing the trade with the benefit of the price sensitive information available to no-one else? How is that fair to the market as a whole? In any event, are there not legal and policy issues arising from the existence of the defence with the procuring provisions?"[81]

315. There is no equivalent statutory civil defence in Australian legislation. However, civil liability of an insider to a counter-party requires that the counter-party "did not possess the information."[82] In effect, this gives an equal information defence where the counter-party has actual knowledge. The defence appears to apply, however, where the counterparty did not know, but ought reasonably to have known of the relevant information.

316. A company whose securities are traded, but which is not a party to the transaction may also have a civil remedy under the Australian regime. In this context a counter-party equal information defence is irrelevant, as the company is not a transacting party.

Questions for Submissions

39. Should there be a criminal and/or civil equal information defence?

Procedures to Allow Trading by Certain Insiders

317. Section 8(1) of the Securities Amendment Act 1988 provides an exemption for a director, company secretary, or employee of a public issuer if the securities are purchased in the name of that person or the name or on behalf of that person's spouse or child, and that the person complied with a procedure operated by the public issuer (which has been approved by the Commission). The procedure must be set up to ensure that no director, company secretary or employee who has inside information about the securities of the public issuer uses that information in selling or

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[80] Section 1043M of the Corporations Act 2001.

[81] Joe Longo *Insider Trading- Fundamental Review: Commentary on Draft Discussion Document* (22 August 2001).

[82] Section 1043L (3)(4) Corporations Act 2001.

buying securities for personal gain. The exception does not apply to trading in the securities by a substantial security holder.

318. A public issuer is not bound to put in place such a procedure but if it does and the trading complies with the notice then the trading will not breach the insider trading provisions.

319. The procedure approved by the Commission for the trading of public issuers generally is set out in the *Insider Trading (Approved Procedure for Company Officers) Notice 1996.* The notice provides two procedures for trading in securities. Procedure I allows a director, company secretary or employee to trade in the shares of a company provided certain steps are completed. The second procedure involves non-standard trades including buying or selling securities in the context of a compromise, arrangement or amalgamation, the taking up of shares offered in a prospectus, or a bonus share issue.

Questions for Submissions

40. Should there still be an exception that allows trading by certain insiders if approved procedures are followed?

Takeovers

320. The Securities Amendment Act 1988 also provides that no action shall be brought against an insider in respect of the purchase of securities which results from an offer made by the insider pursuant to any takeovers code that is in force under section 28 of the Takeovers Act 1993. The rationale for this exception is that the code contains requirements for disclosure that should reduce the risk for those intending to trade with an insider.

321. If the information connection only approach is taken and an exception for knowledge of a persons' or entities' own intentions or activities is implemented this would mean that a potential offeror would not breach the insider trading provisions by dealing in the securities of a potential target prior to a takeover offer.

322. However, this exception may not be wide enough to allow a person with knowledge of a potential bid to discuss the bid with others in order to encourage a competitive bid for the securities. The solicitation of competing bids may be in the interests of the holders of securities, but not in the interests of the other bidder.

323. In the takeovers context, liability may also arise where the acquirer obtains inside information when undertaking due diligence on the issuer. While the takeovers exception will apply if an offer is subsequently made under the Takeovers Code, there is no exception available to the issuer who may communicate inside information to a potential bidder. Liability may arise under section 9(1)(b) of the Securities Amendment Act 1988 because the issuer may communicate the information, knowing or believing that the person will or is likely to buy or sell securities of the issuer.

324. In practise, this issue is dealt with by the potential acquirer signing a confidentiality agreement that prohibits the acquirer from purchasing shares except in accordance with an offer made under the Takeovers Code or until the relevant information has been made public. However, this may not be enough to avoid liability under the Act. If an offer does not proceed or if the inside information is made public, then liability may still arise, as the issuer may still have had the belief that the acquirer will buy securities at the time the information was disclosed.

Questions for Submission

41. Should there be an exception for takeovers? To whom, and how should the exception apply?

Civil Derivative Liability

325. In most jurisdictions bodies corporate and partnerships holding inside information are liable for any trading done on their behalf where any inside information is held within the entity, unless they have effective chinese walls to quarantine the inside information from the person who trades. However, they are not liable where any informed person within the entity trades on his or her own behalf, not on behalf of the entity.

326. By contrast the United States legislation imposes derivative civil liability in some circumstances.

327. Any person who is in a position to control another person may be subject to derivative civil liability for any impermissible trading or tipping by that other person. That liability may be up to three times the profit gained or loss avoided by the insider or the insider's direct tippee.[83] A "controlling person" is defined as "any person with power to influence or control the direction or the management, policies, or activities of another person." Control is inferred from possession of such power, whether or not it is exercised.[84]

328. A controlling person has derivative civil liability for any insider trading or tipping breach by a controlled person where it is established that:

> "the controlling person knew or recklessly disregarded the fact that such controlled person was likely to engage in the act or acts constituting the violation and failed to take appropriate steps to prevent such act or acts before they occurred."[85]

329. In consequence, a controlling person may not deliberately disregard circumstances suggesting that a controlled person is breaching the insider trading

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[83] Insider Trading and Securities Fraud Enforcement Act s 21A(a)(3).

[84] Langevoort, *Insider Trading: Regulation, Enforcement and Prevention*, §8.02[2][b], 8-16.

[85] Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(A).

provisions. The clearest example of reckless disregard would be where a controlling person has no, or an apparently inadequate, internal system to control access to, or dissemination of, confidential price-sensitive information, where such information exists or is likely to exist.

330. The express rationale for imposing derivative liability is that insider trading may be an institutional, as well as an individual, problem:

> "Firms whose lifeblood is the continued public trust in our securities markets must do more to share in the responsibility for policing those markets and should be subject to considerable penalties for a shirking of that responsibility."[86]

331. Controlling persons who are securities issuers may take various preventative steps to avoid derivative liability, including education of employees, controls over the internal dissemination of confidential price-sensitive information and reporting and other internal controls over trading in their own securities, particularly short selling or options trading in those securities. These precautions may help to rebut any claim that the securities issuer recklessly disregarded the risk of illegal insider trading by its employees.[87]

332. Other organizations such as law or accounting firms or banks that regularly come into possession of material non-public information could also take preventative steps to minimise the possibility of insider trading abuse and any derivative liability. These steps could include prohibiting or controlling transactions in the securities of particular clients, internal reporting requirements for securities trading by partners or employees, and requirements that any securities trading be executed through a designated brokerage firm.[88]

333. Under United States law, a controlling person may also be jointly liable in any private civil suit brought against an insider trader "unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."[89] One commentator suggests that a controlling person may be liable if there has been a reasonably serious breakdown in (or the non-existence of) the sorts of controls that such a person should be expected to adopt to deal with the problem of insider trading.[90]

334. United States brokers or investment advisers have an additional basis for derivative liability. They may be civilly liable for any insider trading or tipping breach by an employee where they knowingly or recklessly failed to establish, maintain or enforce written policies and procedures reasonably designed to prevent the misuse

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[86] United States House of Representatives, *Report into the Insider Trading and Securities Fraud Enforcement Act* (1988), 14-15.

[87] Langevoort, *Insider Trading: Regulation, Enforcement and Prevention*, §12.03[1][b], 12-12 to 12-16.

[88] Ibid., §12.03[2] and 12.03[3], 12-27 to 12-34.

[89] Insider Trading and Securities Fraud Enforcement Act 1988 s 20(a).

[90] Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* §12.03[1][c], 12-16 to 12-21.

of material non-public information, and that failure substantially contributed to or permitted the occurrence of the act or acts constituting the violation.[91] This nexus between the failure of the supervisory system and the insider trading is established on proof that the breakdown or failure permitted or provided some assistance to the underlying violation.[92]

335. The arguments for imposing a civil derivative liability exception is that arguably, any organization that has inside information should have some responsibility to reduce the opportunities for its officers, partners or employees to trade on their own behalf while aware of inside information.

336. Opponents, however, argue that it may reduce any incentive for firms to voluntarily notify the regulator and assist in the investigation of possible insider trading within their organizations, given a concern that the regulator may subsequently commence a derivative liability action against them.

Questions for Submissions

42. Should civil liability be imposed on any person who is in control of another person who carries out impermissible trading or tipping?

43. If so, should brokers or investment advisers have an additional basis for derivative liability?

Co-Ordination with Australia

337. Last year the New Zealand government signed a memorandum of Understanding on Co-ordination of Business Law with Australia. The MOU reflects the desire of the Australian and New Zealand governments to deepen the trans-Tasman relationship within a global market, through increased co-ordination of business law, thereby creating a mutually beneficial commercial environment.

338. In light of our commitment under the MOU and the obvious advantages of co-ordinating our law with Australia (for example divergence in the two countries' regulation would entail learning costs for investors and sellers in both countries in understanding different regimes) these factors should be taken into account when deciding what the rationales and content of our insider trading regime should be.

Questions for Submissions

44. In light of New Zealand's commitment under the MOU and the advantages of co-ordinating our law with Australia are there strong reasons, other things being

[91] Insider Trading and Securities Fraud Enforcement Act 1988 s 21A(b)(1)(B). The elements of this statutory requirement are analysed in Langevoort, *Insider Trading: Regulation, Enforcement and Prevention* §12.05, 12-39 to 12-44.

[92] Ibid., §8.02[2][c], 8-23.

equal, for New Zealand to follow the Australian approach to insider trading law? Could you give any reasons why the costs of adopting the Australian approach (generally, or in relation to particular issues) will outweigh the benefits?