Ministry of Economic Development
Manatū Ōhanga

Reform of Securities Trading Law: Volume Three: Penalties, Remedies and the Application of Securities Trading Law

Discussion Document

May 2002

ISBN-0-478-24270-0

Table of Contents

Summary of Questions for Submissions

1. Should the $20,000,000 asset test for unlisted companies remain in the Takeovers Act? If so, how can it be clarified (for example by stating the time at which and the method by which the assets must be calculated)?

2. Should there be more guidance given for the term “shareholder” in the Takeovers Act 1993? If so, should the definition be similar to that given for shareholders in section 96 of the Companies Act 1993?

3. Should relatively small shareholdings be combined for the purpose of calculating the threshold? If so, how?

4. Should the companies listed on the New Zealand Stock Exchange’s New Capital Market be excluded from the Takeovers Act? If so, why?

5. Do you think the Takeovers Code should apply to listed companies which have no equity securities (within the meaning of section 2 of the Takeovers Act) quoted, and which do not fall within paragraph (b) of the definition of "specified company”?

6. Should the application of the Takeovers Act be extended to listed unit trusts and/or unlisted unit trusts and/or group investment schemes and/or other issuers of participatory securities? If it should be extended to unit trusts does there need to be any amendment made to the Unit Trusts Act 1960?

7. Which approach/approaches should be taken to the application of our insider trading legislation:

   - Application to listed issuers; and/or
   - Application by reference to jurisdiction; and/or
   - Application by defining issuers; and/or
   - Application to transactions through or by intermediaries; and/or
   - Application to all issuers.

8. If the insider trading prohibitions should apply to listed issuers only, should they apply to:

   - on-market transactions only;
   - all transactions in quoted securities only; or
   - all transactions in all securities?

9. Should insider trading law apply to:

   - acts and omissions in New Zealand in relation to issuers, no matter where incorporated;

   - acts and omissions outside New Zealand in relation to issuers listed on a New Zealand stock exchange or incorporated or carrying on business in New Zealand. Should issuers with their primary listing on other specified exchanges that are covered by the insider trading law of another jurisdiction be excluded?

10. Should the application be extended to transactions in securities of issuers whose securities are traded in "established markets"? If so, how should "established markets" be defined?

11. Should insider trading law apply to unquoted securities of issuers that have a listing agreement with a registered stock exchange?

12. How and to what extent should insider trading law apply to derivatives? If so, should the law apply to all derivatives or just to derivatives traded on a public exchange in New Zealand? Should the insider trading law apply to derivatives where the underlying asset is not covered by insider trading law?

13. How and to what extent should the insider trading law apply to interests in superannuation schemes? If so, should it apply to entry and/or withdrawal and/or switching between funds?

14. How and to what extent should insider trading law apply to insurance policies? If so, which type?

15. How and to what extent should the insider trading law apply to units in unit trusts, interests in group investment funds and other participatory securities?

16. How and to what extent should insider trading law apply to unallocated beneficial interests in securities held by trustees?

17. Should the continuous disclosure regime apply to unlisted issuers? If so, to which unlisted issuers should the requirement apply? How should these unlisted issuers make disclosure?

18. If you are of the view that further market manipulation provisions should be introduced, to what entities, products and markets should they apply?

19. Should a general prohibition on misleading or deceptive conduct in relation to securities have a wide application? If so, how should it apply?

20. Should criminal penalties be introduced for insider trading, continuous disclosure and market manipulation in New Zealand?

21. If criminal penalties should be introduced, do you think that they should replace, or be added to any civil remedies and penalties?

22. Should an insider trading offence have a *mens rea* requirement, or be an offence of strict or absolute liability?

23. What might a *mens rea* requirement for possession of information be?

24. Can possession be presumed in certain situations?

25. Should there be a requirement for knowledge that the information is price sensitive?

26. Should there be an additional *mens rea* requirement for the tipping offence?

27. Should the *mens rea* requirement be an element of the criminal offence only and not necessary to prove civil liability?

28. Should market manipulation offences have *mens rea* requirements, or be offences of strict or absolute liability?

29. Should the *mens rea* requirements be elements of the offence to be proved by the prosecution, or should they give an accused a defence?

30. Should the *mens rea* requirement be an element of the criminal offence only and not necessary to prove civil liability?

31. Should there be a distinction between what the prosecution has to establish in a criminal proceeding and a civil proceeding?

32. What defences to insider trading should the Crown have to negate beyond reasonable doubt? For what defences must the accused bear the burden of proof on the balance of probabilities?

33. What defences should there be to market manipulation offences?

34. Should the market manipulation law require the defences to be negated by the prosecution, or proved by the accused?

35. Which body or bodies should have responsibility for investigating and/or prosecuting offences for insider trading?

36. If the Serious Fraud Office or the Registrar of Companies were empowered to undertake criminal actions, what, if any, role should the Commission play?

37. In light of your previous answers on which body would be the appropriate investigating and prosecuting authority, do any changes need to be made to that authority in relation to the privilege against self-incrimination?

38. Should the Law Commission's recommendations for the law relating to the privilege against self-incrimination be adopted for civil and criminal proceedings for insider trading, market manipulation and continuous disclosure?

39. If insider trading attracts a civil pecuniary penalty should the privilege extend to information that may render the person liable to a civil pecuniary penalty?

40. What level of penalty should be imposed for criminal offences of:

    - insider trading
    - continuous disclosure; and
    - breach of market manipulation law.

41. Should the High Court or District Court have jurisdiction to hear insider trading, continuous disclosure or market manipulation charges?

42. Should the accused in a continuous disclosure trial, insider trading trial or market manipulation trial have a right to be tried by jury?

43. Should the law allow direct counter parties to trades with insiders a cause of action against an insider trader?

44. Should the law allow contemporaneous traders a direct cause of action against an insider trader? If so, how should the concept of contemporaneous trading be defined?

45. Should the issuer have a cause of action against an insider trader? Should the derivative action by members be retained?

46. Should persons who have suffered loss caused by actions that breached the market manipulation provisions be able to bring civil action for damages?

47. Should the law provide guidance to assist in calculating the damage caused by insider trading or market manipulation? If so, what indicators should be used?

48. Should New Zealand have a civil penalties regime for insider trading, market manipulation and continuous disclosure like that in Australia?

49. If so, what should the maximum penalty be?

50. How should criminal prosecutions and civil penalty proceedings interrelate?

51. Should the Securities Commission be given the power to impose financial administrative penalties?

52. Do you think a court should be able to make a wide range of orders for breach of insider trading law, continuous disclosure law and market manipulation law? What orders would be appropriate?

53. Do you think that the Securities Commission should be given the ability to apply to the court for any of the orders that the court can give?

54. When should the orders be made available?

55. Should bounties be payable by the Securities Commission? If so, what limits should there be on payment?

56.	Should the definition of “serious wrongdoing” in the Protected Disclosures Act be extended to cover insider trading and market manipulation?

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 Three: Penalties, Remedies and the Application of Securities Trading Law
Attention: Kirstie Drake
Ministry of Economic Development
PO Box 1473
Wellington
Tel: 04-474 2887
Fax: 04-471 2658

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

Please note that 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

The Ministry of Economic Development acknowledges the assistance it derived in developing this paper from the New Zealand Securities Commission, Robyn Dey (Senior Associate, Simpson Grierson) and Joseph Longo (Special Counsel, Freehills).

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.

2. Penalties that are sufficiently high and that are 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, appropriate and effective penalties and remedies also need to be developed. This document considers the possibility of implementing criminal sanctions for securities trading law and what improvements could be made to our current civil and administrative remedies.

3. The Takeovers Act 1993 has been enacted for 8 years and Part I of the Securities Amendment Act 1988 has been in force 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 appropriate to consider which entities and financial products Part I of the Securities Amendment Act 1988 and the Takeovers Act 1993 should apply to.

4. 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, the New Zealand's securities 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 at a first principles review of our insider trading law.

5. The government has also introduced the Securities Markets and Institutions Bill. The Bill 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.

6. 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.

Executive Summary

Part I: The Application of Securities Law

7. Part one of the discussion document considers the application of securities trading law. In particular it considers which entities and financial products takeovers law, insider trading law, a continuous disclosure regime and possible market manipulation law should apply to.

Part II: Penalties and Remedies

8. Part two considers the possible introduction of criminal penalties for insider trading, continuous disclosure and potential market manipulation law. It considers the elements and standards of proof that would be required for a criminal offence.

9. In addition, it outlines a number of improvements that could be made to civil remedies, including among other things the possibility of having civil penalties and a wide range of court remedial orders. Part two also considers how possible criminal penalties could interface with civil liability provisions and what level of criminal and civil pecuniary penalties may be appropriate.

10. Finally, the discussion document discusses which state agency should be responsible for investigating and prosecuting criminal offences and whether bounties and protections for whistleblowers should be implemented.

Part I: The Applications of Securities Law

11. The Takeovers Act 1993 has been enacted for 8 years and Part I of the Securities Amendment Act 1988 has been in force 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.

12. While previously securities trading law was for the most part confined to issuers that were listed on a public market and equity securities, increasingly there is a trend internationally for legislation to cover a wider range of issuers and financial products.

13. This may be a result of the fact that the global securities and futures industry is changing rapidly and exchanges are facing increasing competition from each other and from independent low cost trading systems, which bypass traditional exchanges.

14. Technological advances have lowered the entry barriers to establishing new exchanges and this has led to widespread emergence in recent years of alternative and proprietary trading systems which are executing trades outside traditional exchanges, between large participants at low cost and competitive speed. Examples include screen based trading systems owned and operated as independent businesses by non-self-regulatory organisations and automated trading systems which consist of internal trade crossing systems operated by large intermediaries.

15. Further, overseas markets are rapidly integrating by linking together trading, clearing and settlement functions into a single transaction chain. They are also integrating across product lines by combining stock and futures products into a single organisation and developing alliances with other exchanges.

16. The range of securities and futures products available to investors and issuers is also expected to expand, especially in the fixed income and derivatives areas.

17. All of these trends mean that it is difficult to define the “public market”, as the concept of a market is changing dramatically. As technology advances, the threats to the traditional exchange “public market” structures will only increase and the types of financial products will continue to develop. Further, there may be more alliances and possible mergers as exchanges try to compete in the global market. For this reason careful consideration needs to be given as to how we define which entities and products our securities law should apply to. The application of our securities trading law needs to be flexible in order to move with new developments.

18. This part discusses the application of:

- Takeovers Law;
- Insider Trading Law;
- The Continuous Disclosure Regime; and
- Market Manipulation law.

Application of the Takeovers Act 1993

19. The Takeovers Act 1993 applies to "specified companies". A "specified company" is a company registered under the Companies Act 1993[1] that is either a "public issuer" or has fifty or more members or shareholders and $20 million or more of assets.

20. A "public issuer" means a company that is party to a listing agreement with a stock exchange, or a company that is not party to a listing agreement with a stock exchange but was a party to a listing agreement with a stock exchange at any time during a period of 12 months before any date or occurrence of any event referred to in the Code.

21. Several issues have been raised with the current application of the Takeovers Act 1993:

- Should the $20,000,000 asset threshold be removed or more guidance given in the legislation as to when and how assets are to be valued?
- Should more guidance be given in relation to the term “shareholders"?
- Should companies listed on the New Zealand Stock Exchange's new capital market be excluded?
- Should the Act capture listed issuers whose debt securities only are quoted?
- Should the Act cover listed issuers who only issue equity warrants over equity securities issued by other companies? and
- Should listed unit trusts be covered?

22. These issues are discussed below in relation to which entities the Takeovers Act should cover and then in relation to which financial products should be covered.

To Which Entities Should the Takeovers Act 1993 Apply?

Application to Unlisted Companies

23. Submissions on the Takeovers Code and the Takeovers Amendment Bill raised problems with the two-part test for non-listed companies in the Takeovers Act 1993. One of the problems identified was that the definition gives no guidance as to the relevant time for determining whether the asset threshold has been met or on what basis the assets should be valued. This may mean that it is difficult for a non-insider to determine whether or not the $20,000,000 threshold has been met.

---

[1] The company must be registered under Part II of the Companies Act 1993, or reregistered under the Act in accordance with the Companies Registration Act 1993. The Takeovers Act 1993 does not apply to bodies corporate incorporated outside New Zealand.

24. Some commentators have submitted that reference should be made to the most recent financial statements of the company, prepared in accordance with the Financial Reporting Act. However, these may not be publicly available if a company is not required to register its financial statements under the Financial Reporting Act. Further, even if there is a requirement to register, the issuer may not have complied. Thus, a "hostile" acquirer would have no way of knowing whether the Code applies.

25. One way of resolving the problem with the asset test would be to remove it from the definition of “specified company”, leaving the 50 shareholder test as the only test for a non-listed company. This, it may be argued, is more consistent with the principles of the Takeovers Code of equal treatment and participation. It is the number of shareholders and their ability to participate that is a more relevant consideration as to whether shareholders should have protection of the Takeovers Act rather than an asset threshold.

26. Section 606 of the Australian Corporations Act applies Australian takeover law to unlisted companies with 50 or more members. There is no additional asset threshold.

27. It appears that the second part of the definition of "specified company" was added to the Takeovers Bill at a late stage by a supplementary order paper in order to provide a higher threshold for unlisted companies. If the intention of the Act is to apply the Code to a smaller number of unlisted companies of a larger size, then an asset test of $20,000,000 may ensure that only these will be caught. Further, removing the asset test will lead to more companies being captured under the definition and additional compliance costs for these companies. This compliance cost needs to be balanced against the uncertainty of the definition.

Shareholders

28. As stated above the definition of “specified company” in the Takeovers Act 1993 covers any company with 50 or more members or shareholders and $20,000,000 or more of assets. The definition of “code company” in the Takeovers Code includes a company with 50 or more shareholders and $20,000,000 or more of assets.

29. It has been argued that there is uncertainty as to how the term “shareholder” accounts for persons whose interests are represented on the share register by nominee or trustee companies. For example, where a trustee holds shares for 50 members of a staff share purchase scheme is there one shareholder or 50?

30. It has been suggested that it may be helpful if the term “shareholder” was defined in the Takeovers Act 1993 to give more clarity.

31. The term shareholder is defined in section 96 of the Companies Act 1993. This section states:

> “In this Act, the term “shareholder” in relation to a company means-
>
> (a) A person whose name is entered in the share register as the holder for the time being of one or more shares in the company;

(b) Until the person is entered in the share register, a person named as a shareholder in an application for the registration of a company at the time of the registration of the company;

(c) Until the person's name is entered in the share register, a person who is entitled to have that person's name entered in the share register under a registered amalgamation proposal as a shareholder in an amalgamated company".

32. It may be useful to use a similar definition in the Takeovers Act 1993 to define shareholders.

33. It has also been suggested that the Takeovers Act should not apply to unlisted companies with more than 50 shareholders, where a large number of the shareholders hold a small percentage of the shares. For example, where a number of employees of the company hold a small percentage of the shares under an employee share scheme. The Act could combine relatively small shareholdings for the purpose of calculating the number of shareholders. This would be possible only where the company was effectively "closely held" by the dominant shareholders, for example, where less than 5 persons hold 95% of the shares.

34. On the other hand it could be argued that all shareholders in companies with 50 or more shareholders should have the protection of the Takeovers Act. Furthermore employee share schemes are usually implemented by the majority holders who would have been aware that by implementing the scheme, the Takeovers Act may apply.

New Capital Market Issuers

35. It has also been suggested that companies listed on the New Zealand Stock Exchange's New Capital Market should not be covered by the Takeovers Act. The reason given for excluding New Capital Market companies from the Act is that in a company's start-up phase, there may be significant changes of ownership and these companies need flexibility in order to grow. In many cases although these companies may be widely held, they may not meet the asset test. This issue will be important if a decision is made to remove the asset test from the definition of specified company.

36. The alternative view is that there are no justifiable policy reasons for excluding New Capital Market ("NCM") listed companies. These companies are listed, can be widely held, and the fact that they are new is not sufficient justification for removing from their shareholders rights of equal treatment and participation. Significant changes of ownership are not likely because securities held by "New Capital Market Associates" are subject to selling restrictions, these can be released as to one third of the securities on each anniversary of the latter of the issue or acquisition date or completion of the key transaction. "NCM Associates" includes directors and officers of the NCM Issuer, persons with a relevant interest in 20% or more of the equity securities of the NCM issuer and their respective "Associated Persons". It can also be argued that if New Capital Market companies are exempted, then all small listed companies should be exempted for similar reasons.

To Which Financial Products Should the Takeovers Act 1993 Apply?

Equity Warrants and Debt Securities

37. There seems to be general agreement that the Takeovers Act 1993 should cover companies incorporated in New Zealand whose voting securities are quoted on a stock exchange. However, there is debate as to whether the Takeovers Act should cover those listed companies whose debt securities or equity warrants only are quoted.

38. While the Takeovers Act is quite specific where it refers to the type of company that is covered, it contains oblique references to types of securities to which the Takeovers Code may apply. The Takeovers Act contains no definition of "takeover" and provides a very general indication of the types of transactions the Takeovers Code might cover.

39. Under section 20(1), the Takeovers Panel is required to consider a number of objectives as the objectives for the code, including:

> "(c) Assisting in ensuring that the holders of securities in a takeover are treated fairly."

40. Among other things, Section 21 requires the Panel to consider whether the Code should provide:

> "(b) that in a takeover, the specified company and its security holders should be fully informed:
>
> (c) that in a takeover, offers should be made to all security holders, that the consideration offered should be the same for all security holders, and that all security holders should have the same opportunity for acceptance."

41. "Security" is defined in section 2 of the Takeovers Act, to mean, in relation to a specified company:

> "(a) An equity security within the meaning of section 2 of the Securities Act 1978, whether or not the security carries voting rights:
>
> (b) A debt security within the meaning of section 2 of the Securities Act 1978 which carries the right to vote at any annual or general meeting of the specified company:
>
> (c) A participatory security within the meaning of section 2 of the Securities Act 1978 which carries the right to vote at any annual or general meeting of the specified company,—
>
> and includes a security that is convertible, at the option of the security holder, into a security of the type referred to in paragraph (a) or paragraph (b) or paragraph (c) of this definition."

42. Takeovers law regulates the change of control of companies. Changes in control of companies are effected by changes in control of the voting rights. For this reason

it has been argued that there is good reason to exclude from application of the Act entities whose voting securities are not quoted. Entities which only have debt securities or equity warrants over shares in other companies quoted are usually wholly owned special purpose vehicles. For this reason it is contended that the shareholders of these closely held companies do not need the protection of the Code as they have complete control of the company. These companies would often not be covered by paragraph (b) of the definition of “specified company” if they were not listed.

43. Further, it has been argued that the holders of the quoted securities issued by such issuers do not derive benefit from the Takeovers Code as they could not participate in a Code offer. The Code requires partial offers to be made to holders of voting securities, being "equity securities" that confer voting rights. A full offer must be made to holders of all classes of equity securities of the target company. "Equity Security" is defined in Rule 2 of the Code:

- to mean any interest in or right to a share in, or in the share capital of, a company (whether carrying voting rights or not); and
- includes an option or right to acquire any such interest or right unless that option or right is exercisable only with the agreement of the issuer; but
- does not include redeemable securities that are redeemable only for cash.

44. Holders of debt securities with no voting rights and no right to convert into shares have no control over the company, nor any such expectation of control. Their contractual rights will normally relate to the other benefits conferred by holding their security, for example rights to receive interest and principal. They may also have rights in relation to the appointment of a trustee. The holder of an equity warrant will have a contractual right to the delivery of the underlying security and the benefits attached. They are unlikely to have any interest in the control of the issuer of the warrant beyond this. Until they exercise their warrant, they are unlikely to have any interest in the underlying security. Therefore, the warrant will not be an "equity security" of the issuer of the underlying security, so a bidder in a full offer would not be required to make an offer to warrant holders. For these reasons the definition of equity security in the Code seems appropriate.

45. However, in some cases there may be contractual terms inhibiting the right of the shareholder to dispose of its shares in the company, for example if the debt securities are convertible into shares in the parent, or if the parent guarantees repayment of the securities.

46. The Takeovers Act could be amended to exclude from the definition of public issuer, companies which do not have any equity securities (within the meaning of section 2) quoted on a stock exchange and to which paragraph (b) of the definition "specified company" does not apply, provided the quoted securities are not also equity securities in a specified company. It is unlikely that this will create any problems with the Code. As mentioned above, holders of these securities are not covered under the Code currently.

Unit Trusts

47. A number of submissions on the Takeovers Code and the Takeovers Amendment Bill suggested that the application of the Takeovers Act be extended to cover unit trusts, in particular listed unit trusts.

48. Many people find it inconsistent that the acquisition of shares in a listed investment company is subject to the takeover provisions but the acquisition of units in a listed unit trust, which performs substantially the same activities is not. It has been argued that although a unit is legally very different from a share, some of the rights attached to units often approximate rights to shares. Unit holders are often in similar commercial position to shareholders with respect to returns on their investment. Further, together the manager and the trustee perform functions similar to those performed by directors of a company.

49. For this reason it has been suggested that securities and investment products should be regulated in a neutral way to avoid "regulatory arbitrage" and corresponding inefficiencies. Unit holders should have the same opportunity to participate in a takeover of a unit trust and have the right to share in a premium for control as shareholders.

50. Opponents to the extension of takeovers legislation to unit trusts contend that although a unit trust could be a target in a takeover offer, there are significant differences in the structure of unit trusts established under the Unit Trusts Act 1960 and companies incorporated under the Companies Act 1993. These differences may indicate that under the current legal framework, listed unit trusts should not necessarily be regulated in the same way as listed companies.

51. The following key differences have been identified:

- Unit trusts are investment vehicles established so investors can pool their money for investment in assets. Companies can also be used for this purpose, but unit trusts are less likely to be used as a business vehicle in the way that companies are. In practice, these distinctions can be narrowed and some unit trusts closely resemble companies in their business and practices.

- The control of a company is effected by changes in ownership and control of the voting securities. This control is evidenced by an ability to appoint and dismiss the board of directors. While the Manager of a unit trust performs a similar role to the board of directors of a company the unit holders do not have the same ability to appoint and remove the manager. Sections 18 and 19 of the Unit Trusts Act 1960 require a resolution of a holder or holders of 75 percent of the value of the units on issue to remove a manager of a unit trust. The shareholders of a listed company may remove a director by ordinary resolution, that is a resolution approved by a simple majority of the votes of those shareholders entitled to vote and voting.[2] This is a much lower threshold.

---

[2] Section 105(2) Companies Act 1993.

- Another means of acquiring control of the assets of a unit trust would be to acquire the management contract or acquire the manager itself. Unit holders are unlikely to have any say in either of these matters.

52. The takeover provisions in the Australian Corporations Act (section 604) have been extended to apply to relevant interests in the interests of listed managed investment schemes registered in the jurisdiction as if the schemes were listed companies.

53. This extension of the application of Australian takeovers law to managed investment schemes coincided with a change to the legal framework for Australian unit trusts. Significant changes were made that included the removal of the requirement for a trustee and the change in role of a manager to a "responsible entity".

54. Under the Australian regime members of a listed managed investment scheme now have greater powers to control the appointment and removal of the responsible entity. Under section 601FL of the Corporations Act, the appointment of a new responsible entity on the voluntary retirement of the incumbent must be approved by ordinary resolution of the members. Under section 601FM, the members of a listed managed investment scheme may remove the responsible entity by ordinary resolution. An ordinary resolution is one passed on a show of hands or on a poll, passed by at least 50% of the votes cast by members entitled to vote on the resolution.

55. Similar policy reasons for extending or not extending the Takeovers Act to listed unit trusts might also apply to unlisted unit trusts and to group investment funds and other contributory schemes involving the issue of participatory securities.

Questions for Submission

1. Should the $20,000,000 asset test for unlisted companies remain in the Takeovers Act? If so, how can it be clarified (for example by stating the time at which and the method by which the assets must be calculated)?

2. Should there be more guidance given for the term “shareholder” in the Takeovers Act 1993? If so, should the definition be similar to that given for shareholders in section 96 of the Companies Act 1993?

3. Should relatively small shareholdings be combined for the purpose of calculating the threshold? If so, how?

4. Should the companies listed on the New Zealand Stock Exchange’s, New Capital Markets be excluded from the Takeovers Act? If so, why?

5. Do you think the Takeovers Code should apply to listed companies which have no equity securities (within the meaning of section 2 of the Takeovers Act) quoted, and which do not fall within paragraph (b) of the definition of "specified company”?

6. Should the application of the Takeovers Act be extended to listed unit trusts and/or unlisted unit trusts and/or group investment schemes and/or other

issuers of participatory securities? If it should be extended to unit trusts does there need to be any amendment made to the Unit Trusts Act 1960?

Application of Insider Trading Laws

56. This section considers which entities and financial products any potential insider trading regime should apply to.

57. The current prohibition against insider trading is found in Part I of the Securities Amendment Act 1988 and only applies to transactions in securities of public issuers.

58. A "public issuer" means:

> "(a) a person who is party to a listing agreement with a stock exchange; or
>
> (b) a person who was previously a party to a listing agreement with a stock exchange, in respect of any action, event or circumstance to which this Act applied while the person was a party to a listing agreement with a stock exchange."

59. The application of the Act follows closely the recommendation the Securities Commission made in its Insider Trading Report in December 1987.[3]

60. This section considers the application of insider trading by entity and financial product. When considering the application of insider trading law it is also important to consider the rationales behind any insider trading regime implemented (see paragraphs 44 to 68 in the *Reform of Securities Trading Law: Volume One: Insider Trading: Fundamental Review* discussion document). The rationales chosen for an insider trading regime play an important role when considering which entities and financial products the law should apply to. For example, the market efficiency principles will be more focused on the impact on the market and the fiduciary duty rationale on relationships between individuals.

The Application of Insider Trading Law by Entity

61. International jurisdictions have taken a variety of approaches in determining which entities their insider trading prohibitions should apply to. These include:

- Application to listed entities only;
- Application by reference to jurisdiction;

---

[3] The Commission at paragraph 7.5 of that report stated that they were mainly concerned about dealings that affected the public market. They suggested the proposals would be appropriate in respect of insiders of all companies but would not object to a proposal to limit the application to insiders of companies that are listed on the New Zealand Stock Exchange. They did not limit the proposals to transactions on the exchange or to securities that are listed on the exchange.

- Application by defining issuers;
- Application to transactions through or by intermediaries; and
- Application to all issuers.

Application to Listed Entities

62. All jurisdictions that regulate insider trading apply the prohibition to entities whose securities are listed on the national stock exchange. In part this is because these issuers are normally subject to continuous disclosure requirements contained in legislation or under the rules of the exchange. These disclosure requirements result in a general expectation that all material price-sensitive information will have been disclosed to the exchange (made public) where required. The extension of insider trading provisions to securities of unlisted companies may be more problematic, as it is usually not possible to avoid a breach of the insider trading provisions with respect to these companies as there are not the same disclosure mechanisms available.

63. It has also been argued that the market fairness and efficiency rationales for prohibiting insider trading are concerned with the impact only on the "public markets":

> "On one view, the legislation should be confined to on-market transactions and those off-market transactions that can affect public markets, for instance where the securities involved are publicly tradeable (even if traded off-market) or create an indirect interest in tradeable securities. Also, as the insider trading provisions could cover any transaction involving professional intermediaries, as in some overseas law, given the linkage to, and possible impact on, public markets"[4]

64. It can, however, also be argued that the market should be extended beyond the "public market" to the wider informal market on the basis of the market efficiency rationale. This extension could be justified on the basis that if conduct that the public considers wrong relates to a wider range of issuers and products and hence a wider market, then that will discourage investment in these products. It recognises that investment should be encouraged and protections for investors provided in relation also to this wider, informal market.

65. Some international insider trading regimes restrict the application of their insider trading law to transactions on-market and off-market transactions in quoted securities effected through intermediaries.[5] Others apply the prohibition to transactions in listed securities, whether on-market or off-market.

---

[4] Companies and Securities Advisory Committee *Insider Trading Discussion Paper* 2001 para 2.96.

[5] For example, the United Kingdom Criminal Justice Act 1993. Also, note that in the United States, while the criminal insider trading laws apply to all on-market and off-market trading and securities, the Security and Exchange Commission's statutory power to impose civil penalties only applies to trading on or through the facilities of the National Securities Exchange or from or through a broker or dealer. This emphasises the role of the SEC in protecting the integrity of the impersonal market place. The purpose of the United Kingdom provision is to exclude from the scope of criminal liability a truly private deal executed off-market and without the involvement of a market professional.

66. If the application of insider trading law is restricted to transactions on-market it could be argued that the insider trading prohibition is not effective, as it would not prevent an insider from benefiting from trading on inside information by private arrangement and, therefore, would not prohibit the conduct considered wrong under all of the insider trading rationales.

67. Once the rationales behind a regime have been determined and the legislation applied to certain entities and products, it is important to consider the inter-linkages behind the application and the penalties or remedies imposed. As there is more likely to be a direct counter-party to an off-market trade, civil remedies may be deemed a more appropriate remedy, while criminal penalties may be more appropriate for on-market trades where all the counter-parties are not easily identifiable and the damage is to an easily identified market.

68. Some countries which apply their prohibitions to on and off market transactions alter their penalties and remedies for insider trading breaches, depending on whether the transaction has occurred on-market or off-market. The United States prohibition applies to all on-market and off-market transactions. However, the United States Securities and Exchange Commission ("SEC") powers to impose civil penalties apply to trading "on or through the facilities of a national securities exchange or through a broker or dealer". Parties to off-market face to face transactions have civil remedies.

69. The SEC may obtain up to four times the profit gained by an insider by obtaining dis-gorgement of any profits and a civil monetary penalty of up to three times the profit gained or loss avoided. These funds are held for the benefit of those adversely affected by the activity, primarily those who have suffered out of pocket losses in contemporaneous trading. The total amount of damages awarded in private civil litigation cannot exceed the profit gained or loss avoided in the transaction. Also, the amount of damages recoverable under private civil litigation is reduced by any amount obtained by the SEC relating to the same transaction.

Application by Reference to Jurisdiction

70. Another way of defining the application of insider trading law is by reference to the jurisdiction of the issuer and the place where the relevant activity takes place. Specifically, if the prohibition is only to apply to listed issuers the prohibition could cover securities of issuers that are listed on a New Zealand stock exchange and also those listed on overseas exchanges which have a "New Zealand" connection, for example, an issuer that is established in New Zealand, or is carrying on business in New Zealand. If the prohibition is to apply to securities in unlisted entities, it could also be applied by reference to a New Zealand connection.

71. The Australian regime follows this approach. Under the Corporations Act, the insider trading provisions apply to:

> "(a) acts and omissions within this jurisdiction in relation to Division 3 financial products (regardless of where the issuer of the products is formed, resides or located and of where the issuer carries on business); and

(b) acts and omissions outside this jurisdiction (and whether in Australia or not) in relation to Division 3 financial products issued by:

(i) a person who carries on business in this jurisdiction; or

(ii) a body corporate that is formed in this jurisdiction[6]".

72. The application to activities anywhere in the world in relation to securities of issuers established in New Zealand may be appropriate if the insider trading prohibitions are seen to provide protections and encourage investment in the wider markets for securities of New Zealand based entities and not just the public market in New Zealand. It could remove the possibility of New Zealand being a place of incorporation to avoid the application of insider trading laws. On the other hand, it could be argued that this is a matter for regulation by the country in which the relevant market is situated.

73. The application of the law to activities in New Zealand in relation to entities wherever they may be established could be seen to protect the New Zealand market for securities generally. The extension to issuers carrying on business in New Zealand may be too wide if that is the only New Zealand connection in the transaction.

74. If the prohibition is to cover transactions in securities of listed issuers not conducted on a stock exchange based in New Zealand (off market transactions), or to securities of unlisted issuers, then difficult issues can arise as to the extra-territorial effect of the legislation. These issues arise in relation to transactions conducted by security holders operating out of New Zealand, either privately, or on the stock exchanges of other countries.

75. Where a listed issuer does not have a listing in another country, there may be good reason for New Zealand's insider trading laws to apply to protect the integrity of the New Zealand market. However, where the issuer has a listing in another country that regulates insider trading law, the application of New Zealand law becomes more complex.

76. This is an important issue in the New Zealand market where there are many "overseas listed issuers" whose home exchange is not the New Zealand Stock Exchange. For example, a shareholder in an Australian company listed on the Australian Stock Exchange, who sells shares while in Australia, will be subject to the insider trading provisions of the Corporations Act 2001. If the company has a secondary listing on the NZSE, the shareholder would also be subject to the Securities Amendment Act 1988.

77. If the application of insider trading law is to be limited to issuers listed on a New Zealand stock exchange, and the law covers both on and off market transactions, it

---

[6] Section 1042B of the Corporations Act.

may be appropriate to specify the territorial effect of the law. It could be limited to acts and omissions inside New Zealand where no other insider trading law applies.

Extension to Other "Issuers"

78. Another way of applying the prohibition would be to apply the regime to those issuers which have reporting requirements. This approach is based on the idea that as these issuers have to comply with reporting requirements there is a public expectation that material price sensitive information should be made available to the market and that this market should be protected for market efficiency and fairness reasons.

79. An example of this approach is the Ontario Securities Act 1990. The insider trading provisions contained in the Ontario Securities Act 1990 apply to trading in securities in reporting issuers. A "reporting issuer" under the Ontario Act is similar to an "issuer" under the New Zealand Financial Reporting Act 1993.

80. The New Zealand prohibition could be extended, for example to persons who are issuers within the meaning of section 4 of the Financial Reporting Act 1993. As issuers under the Financial Reporting Act, these entities are already required to make a certain amount of public disclosure by registering financial statements each year. This would apply the prohibitions to:

(a) every person who has, whether before or after the commencement of this Act, allotted securities pursuant to—

- An offer for which, or but for an exemption granted by the Securities Commission pursuant to section 5 of the Securities Act 1978, an investment statement or a registered prospectus, or both, is or was required under that Act (other than an offer of a unit in a unit trust); or
- An offer required to be contained in a prospectus required to be registered under the Companies Act 1955.

—whether or not the securities allotted are securities of the same type as the securities offered;

(b) Every manager of a unit trust (within the meaning of section 2 of the Unit Trusts Act 1960) in which securities have been allotted, whether before or after the commencement of this Act, pursuant to an offer of securities to the public within the meaning of the Securities Act 1978;

(c) Every person who is a party to a listing agreement with a stock exchange in New Zealand and who has issued securities which are quoted on such an exchange;

(d) Every insurer (within the meaning of section 13 of the Accident Compensation Act 1998);

(e) Every registered bank (within the meaning of section 2(1) of the Reserve Bank of New Zealand Act 1989) that has allotted securities to the public within the meaning of the Securities Act 1978.

81. References to securities that have been issued or allotted would be taken as references to securities that have not been cancelled, redeemed, forfeited, or in respect of which obligations owing under them have not been discharged.

82. The inclusion of registered banks solely by reason of their registration may not be warranted. If they had only offered debt securities to the public they would be caught only by paragraph (d) of the definition of "issuer" and not by paragraph (a). As there is little secondary trading in debt securities issued by registered banks, there may be no expectation or need to apply insider trading provisions to all registered banks.

83. It could be argued that as there is not a formalised, centralised method of disclosing price sensitive information on a continuous basis the insider trading prohibitions should not be extended to these issuers. There may be three reasons for this: first there is no expectation that disclosure will have been made. Second, in the absence of a reporting regime, it is not appropriate for insider trading prohibitions to be imposed because there will be too great an uncertainty as to whether certain information has or has not been disseminated widely enough. Finally, extending the regime to these smaller issuers of securities could impose disproportionate compliance or regulatory costs.

84. If the prohibition is to be extended to such issuers, then the continuous disclosure requirements could be extended to cover these issuers. This could provide a formalised and possibly centralised method of disclosing price sensitive information on a continuous basis.

85. Alternatively it can be argued that the application of insider trading legislation should not be confined in this way. In Australia information or material can be publicly available without first having to consult a centralised system. The issue in Australia is whether a reasonable time has elapsed to enable dissemination of the information to occur. Many regimes do not rely solely on a centralised method of disclosure alone for the basis of whether an insider trading regime should or should not apply to an entity (although often release to an exchange may be a useful starting point).

86. If the prohibition is extended to these issuers then arguably it should apply to all securities issued by them.

87. Another method of applying insider trading law to unlisted issuers could be to apply insider trading regulation to those issuers that would qualify as “specified companies” in terms of the Takeovers Act. This would include listed companies and larger unlisted companies.

Application by Reference to Transactions through or by Intermediaries

88. The prohibition could be extended to transactions in securities of unlisted issuers conducted by or through an intermediary.

89. For example, the insider trading provisions contained in the United Kingdom Criminal Justice Act 1993 apply where the acquisition or disposal in question occurs on a regulated market, or where the person dealing relies on a professional intermediary or is acting as a professional intermediary.

90. This approach could be justified on the basis that if an intermediary is involved, then the transaction is taking place on an informed market and there should be prohibitions on insider trading in the interests of market efficiency and fairness on this market. Although there may be no centralised system of continuous disclosure for the relevant issuer, because a professional intermediary is involved, the parties can assume that an intermediary would have access to the publicly available information. The price negotiated should therefore take into account all publicly available non-confidential information.

91. An intermediary could be defined as a person in the business of buying or selling securities on their own account or on the account of others. Persons employed by an intermediary to carry out that activity would also be included.[7] Where the activity was incidental to another activity, or occasional, then that would not be sufficient to make a person an intermediary.

92. This approach, however, would not cover all types of public markets, as electronic trading systems increasingly allow for direct access to markets by traders both with and without a nominal intermediary taking responsibility for the trading.

Extension of Prohibition to All Issuers

93. The prohibition could cover all issuers of securities. This approach could be justified on the basis of both the fiduciary/misappropriation and the market fairness and efficiency rationales.

94. Under the fiduciary/misappropriation theory the approach would be justified on the basis that insider trading law logically applies to all issuers who have the requisite relationship. If the concept or definition of "market" is considered wide enough to cover the informal market of financial products then the market fairness/market efficiency theories would also be justified.

95. Extending the prohibition to all issuers would apply the law to "closely held" issuers. Where continuous disclosure is required of these issuers there would be an expectation of public disclosure. However, where there is no expectation of continuous or any public disclosure by these issuers the issue would not be whether the information has or has not been publicly released but whether the information was known to the counter-party. Parties to these transactions should be in the position to know whether the counter-party is an insider and to negotiate full disclosure where appropriate. These parties will have remedies under the Contractual Remedies Act 1979 and may not need insider trading law to provide a remedy. Another option would be to apply the prohibition to transactions and securities of all issuers to give private civil remedies to those who have suffered loss, however, state enforcement could be reserved where there is a wider "market" and a requirement for the issuer to disclose information publicly. The prohibition could apply to transactions in securities of issuers whose securities are traded in "established markets". This may create problems in defining an "established market".

---

[7] Refer section 59 United Kingdom Criminal Justice Act 1993, United States Securities Exchange Act 1934, s3 paragraphs 4 and 5.

96. The Australian Financial Services Reform Act 2001 applied the insider trading laws to all issuers of shares and debentures, derivatives and managed investment products and to some superannuation products. Financial products that are able to be traded on any financial market will also be covered.[8] This is part of the Australian approach to regulate functionally similar products in a consistent manner and to consider the market as the wider market of investment and financial products.

97. If the prohibitions are to apply to all issuers in this way, it would be necessary to define the relevant "New Zealand" connection. For example, by reference to the establishment of the issuer in New Zealand or the transaction or part thereof taking place in New Zealand.

98. Further, if the prohibition is to extend to all financial products then it needs to be extended to all issuers of these financial products on the basis that these issuers should be regulated in a similar way. It should be noted that this would result in increased compliance costs for some issuers.

Questions for Submissions

7. Which approach/approaches should be taken to the application of our insider trading legislation:
   - Application to listed issuers; and/or
   - Application by reference to jurisdiction; and/or
   - Application by defining issuers; and/or
   - Application to transactions through or by intermediaries; and/or
   - Application to all issuers.
8. If the insider trading prohibitions should apply to listed issuers only, should they apply to:
   - on-market transactions only; or
   - all transactions in quoted securities only; or
   - all transactions in all securities.
9. Should insider trading law apply to:
   - acts and omissions in New Zealand in relation to issuers no matter where incorporated;

[8] Previously, different insider trading provisions applied to derivatives and some superannuation products. These are now to be covered by one regime, which will also apply to “financial products able to be traded on a financial market” as defined.

- acts and omissions outside New Zealand in relation to issuers listed on a New Zealand Stock Exchange or incorporated or carrying on business in New Zealand. Should issuers with their primary listing on other specified exchanges that are covered by the insider trading law of another jurisdiction be excluded.

10. Should the application be extended to transactions in securities of issuers whose securities are traded in "established markets"? If so, how should "established markets" be defined?

The Application of Insider Trading Law by Reference to Type of Security

99. Currently the New Zealand insider trading prohibition applies to securities. "Security" as defined in section 2 of the Securities Amendment Act 1988 means

> "any interest or right to participate in any capital, assets, earnings, royalties, or other property of any person; and includes—
>
> - Any interest in or right to be paid money that is, or is to be, deposited with, lent to, or otherwise owing by, any person (whether or not the interest or right is secured by a charge over any property); and
> - Any renewal or variation of the terms or conditions of any existing security".

100. The meaning of "security" is extended in section 4 of the Act to include:

- "Any form of beneficial interest in a security:
- The power to exercise any right to vote attached to a security:
- The power to control the exercise of any right to vote attached to a security:
- The power to acquire or dispose of a security:
- The power to control the acquisition or disposition of a security by any person:
- Any power which may exist or arise at any time under any trust, agreement, arrangement, or understanding relating to a security to—
  - Exercise the right to vote attached to a security; or
  - Control the exercise of the right to vote attached to a security; or
  - Acquire or dispose of a security; or
  - Control the acquisition or disposition of a security by any person."

101. Section 6A of the Securities Act 1978 is also relevant. It applies to offers to the public of previously allotted securities that are not required to be made in compliance with the Securities Act 1978. This section implies into every offer of a security to

which the section applies that, except to the extent disclosed for the purposes of the offer, the offeror has no information in relation to the original allotter that is not publicly available and that would, or would be likely to, affect materially the price of the security if it were so disclosed.

102. As a general rule the Securities Act 1978 will require disclosure of all "material matters relating to the offer of securities", in relation to offers of securities made to the public.

103. This section examines the application of Australian insider trading law by reference to type of security and then more specifically considers whether New Zealand insider trading law should be applied to:

- Unquoted securities of listed issuers;
- Derivatives;
- Superannuation;
- Insurance;
- Unit trusts/Group Investment Funds;
- Other forms of Trust; and
- Other participatory securities

The Australian Regime: Application by Reference to Type of Security

104. The types of financial products to which Australian insider trading law applies are defined as “Division 3 financial products” in section 1042A of the Corporations Act 2001.

105. Division 3 financial products in 1042A is defined to mean:

(a) securities; or

(b) derivatives; or

(c) managed investment products; or

(d) superannuation products, other than those prescribed by regulations made for the purposes of this paragraph; or

(e) any other financial products that can be traded on a financial market.

106. In effect there may be only a small difference between what the insider trading regime covered before the commencement of the Financial Services Reform Act 2001 in March 2002 and what it covers now. Essentially, the main difference is that insider trading law in respect of futures (now derivatives) and superannuation interests will all be in the same place and treated in a similar manner as the law

applied to securities provisions in the old Division 2A of Part 7.11 of the Corporations Act.

107. The other difference is the inclusion of subparagraph (e) in the definition "…any other financial products that are able to be traded on a financial market".

108. The word "securities" where used in the definition of Division 3 financial products means a share in a body or a debenture in a body. It also includes the legal and equitable rights in such shares and debentures and an option to acquire a security by way of issue.[9] A body is defined as a body incorporate or unincorporate.[10]

109. The term "financial product" was given an elaborate definition by the Financial Services Reform Act. However, as "Division 3 financial products" are given a separate meaning in the insider trading provisions, it is uncertain what the inclusion of paragraph (e) in that definition will mean.

110. The prohibitions on trading when in possession of inside information apply whether or not the securities are listed or able to be traded on any market. The prohibitions on communicating inside information apply to division 3 financial products able to be traded on a financial market.[11]

Unquoted Securities of Listed Entities

111. It has been argued that the insider trading law should not apply to securities of listed issuers that are not quoted on the stock exchange. This is because the relevant connection is said to be between the security and the market and not the issuer and the market. The point most commonly arises in relation to issuers who have debt securities or equity warrants quoted, but whose equity securities are not quoted. These unquoted securities are likely to be closely held. Because of this there is likely to be a limited market for the securities, and the application of the insider trading law to these securities cannot be justified on the market fairness or market efficiency theories.

Derivatives (Futures)

112. New Zealand's insider trading laws do not apply to derivatives, unless they are securities of a public issuer.

113. It could be argued that the insider trading laws should apply to all futures traded on the public futures market in New Zealand. This could be justified on the market fairness/market efficiency theories.

114. It can also be argued that insider trading law should apply to derivatives over securities to which insider trading laws apply and also to derivatives over equity indices. This is because insider trading could take place through an insider taking a

---

[9] Section 761A Corporations Act 2001.

[10] Section 9 Corporations Act 2001.

[11] Section 1043A Corporations Act 2001.

position in these derivatives. This could also be justified for the reason that similar products are tradeable on the NZSE and the New Zealand Futures and Options Exchange ("NZFOE"), and to be consistent, the insider trading prohibitions should apply to futures over equities and equity indices traded on the NZFOE.

115. Part 8.7 of the Australian Corporations Act, before recent amendments by the Financial Services Reform Act 2001, contained provisions regulating insider trading in futures contracts. The prohibitions applied to dealing in a futures contract concerning a body corporate, that is, a futures contract that relates to the securities of a body corporate, or that relates to the price of such securities, or the price of a class of securities including such securities.[12]

116. The prohibitions used the “person connection approach” applying to persons who are connected with a body corporate having inside information in relation to a futures contract concerning that body corporate. The prohibition also applied to a person receiving inside information in relation to a futures contract directly or indirectly from another person where the first person is aware or ought reasonably to be aware that the other person is precluded from dealing in the futures contracts. The prohibitions prevented dealing in futures contracts and also communicating the inside information to others if the person knows or ought reasonably to know that the other person will make use of information for the purpose of dealing in the futures contract.

117. The Financial Services Reform Act 2001 has amended the Corporations Act so that it applies to derivatives as they applied to securities and managed investment products and some superannuation products. These provisions are substantially the same as those contained in Division 2A of Part 7.11 of the Corporations Act 2001. One significant change in this approach will be that insider trading law will apply to derivatives over commodities. The "person connection" approach will also no longer apply to insider trading in futures contracts.

118. There has been discussion in Australia on whether it is appropriate for insider trading law to apply to derivatives over underlying commodities.

> “One argument for extending the insider trading provisions to exchange-traded derivatives over commodities is that permitting people to trade while in possession of inside information could distort the efficient price discovery mechanism of commodities markets and generate uncertainty about whether parties are trading on the basis of price sensitive information.”[13]

119. Another argument is that the insider trading prohibition should not be extended beyond derivatives of equities, for the reason that the prohibition on insider trading of derivatives over equities supports the prohibition on the insider trading of the underlying equities themselves. However, to extend the insider trading provisions to derivatives over commodities would prohibit a person from buying or selling derivatives over a commodity when in possession of confidential price-sensitive information concerning the commodity, although that person could still lawfully buy or

---

[12] Section 1251 Corporations Act 2001.

[13] Companies and Securities Advisory Committee *Insider Trading Discussion Paper* 2001.

sell the physical commodity itself. In consequence, the insider trading prohibition would apply to the derivative, but not to the underlying asset.

120. The opposing argument is that undesirable trading is possible in the commodities derivative market. For example, a person with confidential price sensitive information concerning a very large transaction about to occur in a commodity that would affect the value of futures contracts over that commodity. For this reason it is argued that the insider trading provisions should apply.

Superannuation

121. Although there is no prohibition on transfers of interests in superannuation schemes, in practice interests are not usually transferred other than by way of security. This is because superannuation schemes are by definition established for the purpose of providing retirement benefits to beneficiaries who are natural persons.[14] The potential for insider trading in interests in superannuation schemes is less likely, therefore, than in shares in a listed company.

122. Because there is little or no secondary market, the application of insider trading laws to interests in superannuation schemes could not easily be justified on a market efficiency/market fairness theory. However, it could be argued that if insider trading activity is perceived to exist in relation to superannuation interests this could prevent people from wanting to invest and, therefore, damage the efficiency of the wider, financial market and discourage superannuation saving.

123. There is a possibility for a member of a defined contribution scheme who has inside information relating to the assets of a scheme to take advantage of that information. Where a scheme has different portfolios, a member could switch portfolios in order to avoid a loss or make a gain. The other members could be disadvantaged by this activity depending on how the switch was funded. If the relevant portfolio is "balanced" immediately, then the other members may not be disadvantaged. In this case the member might also "tip" the scheme's manager. However, if the fund is "balanced" over a longer period, the other members may be disadvantaged.

124. A member with inside information about an asset in the fund could withdraw from a fund and thereby benefit by withdrawing before a decline in value. Other members would be disadvantaged depending on how the withdrawal was funded. If from cash, then other members would have a proportionally greater interest in assets that are worth less.

125. There may be little opportunity for insider trading in relation to interests in defined benefit schemes. In these schemes, a member's benefit is determined by reference to length of service and salary. However if a member has inside information relating to the value of the assets of the scheme, then they could time their withdrawal to take advantage of the information. For example if the value of the scheme was to fall, resulting in a shortfall of assets to meet benefits payable, the insider may avoid a loss.

---

[14] Definition of "Superannuation Scheme" section 2 Superannuation Schemes Act 1989.

126. In Australia, the Financial Services Reform Act 2001 will apply insider trading provisions to certain superannuation products.

Insurance

127. Most insurance policies are contracts for a fixed sum. Therefore there is no scope for insider trading, even on transfer. The one exception may be insurance bonds which are unitised investments, giving the holder an interest in an underlying asset. The same issues in relation to switching funds, entry and withdrawal as mentioned in relation to superannuation schemes above would apply to these policies. Also, these are more likely to be transferred.

Unit Trusts/Group Investment Funds and Other Participatory Securities

128. Insider trading is possible with group investment funds and unit trusts. These are unitised investments which are unallocated interests in a trust's assets. Usually these are transferable. For this reason, it is arguable that insider trading law should apply to interests in unit trusts and other group investment funds in the same way it applies to shares in companies. A unit holder with inside information about assets of the trust could also benefit by switching funds within a trust or by acquiring or disposing of units. Note that Part I of the Securities Amendment Act 1988 currently applies to listed unit trusts.

129. Similar arguments could be made for other participatory securities, especially if there is a secondary market for those securities.

Other Forms of Trust

130. The extended definition of "security" includes "any form of beneficial interest in a security". Thus, the provisions would catch an insider who acquired the securities through a trustee and the insider retained a beneficial interest in an identifiable security.

131. However, the definition of security may not catch transactions through trusts where the insider does not have a beneficial interest in a particular security. For example, if a trustee holds securities on an unallocated basis for a number of beneficiaries, then the extended definition may not apply although an insider could acquire an interest in securities in this way. This situation arises where a nominee or trustee provides portfolio services.

Questions for Submission

11. Should insider trading law apply to unquoted securities of issuers that have a listing agreement with a registered stock exchange?

12. How and to what extent should insider trading law apply to derivatives? If so, should the law apply to all derivatives or just to derivatives traded on a public exchange in New Zealand? Should the insider trading law apply to derivatives where the underlying asset is not covered by insider trading law?

13. How and to what extent should the insider trading law apply to interests in superannuation schemes? If so, should it apply to entry and/or withdrawal

and/or switching between funds?

14. How and to what extent should insider trading law apply to insurance policies? If so, which type?

15. How and to what extent should the insider trading law apply to units in unit trusts, interests in group investment funds and other participatory securities?

16. How and to what extent should insider trading law apply to unallocated beneficial interest in securities held by trustees?

Application of Continuous Disclosure Law

132. The Securities Markets and Institutions Bill will implement a statutory continuous disclosure regime on public issuers within the meaning of section 2 of the Securities Amendment Act. These provisions impose a requirement to disclose "material information".

133. While it is important that any statutory continuous disclosure regime complements any insider trading regime developed, the two areas of regulation do not need to be perfectly aligned as each regime is designed to solve a different problem. Continuous disclosure involves an obligation to disclose information to the market, whereas insider trading involves an obligation to refrain from trading when aware of certain information.

134. The imposition of statutory continuous disclosure requirements on issuers whose securities are quoted on a New Zealand based stock exchange would seem to be generally accepted in New Zealand. Even though the current requirements of the New Zealand Stock Exchange are listing rules and not statutory based, publicly listed issuers are used to complying.

135. It has been argued that certain classes of unlisted issuers should also have to disclose under the continuous disclosure regime. The reason given for including such issuers is that there is no reason to differentiate between unlisted and listed issuers if the purpose is to protect the public through disclosure of information. Requiring these unlisted issuers to disclose would ensure that there is a mechanism by which price sensitive information can be disclosed. It would provide a source of information for persons intending to transact in securities of the relevant issuer. It is also useful to company insiders, by providing an avenue to disclose the price sensitive information in order that the insider may trade.

136. The disadvantages of imposing these requirements on other issuers are that there is currently no formal method of disclosure and that it may be necessary to provide for such a centralised system in order to make disclosure simple and cost effective. As there would be an increase in compliance costs it has been suggested that the requirement should only apply to “public” or “widely held” unlisted companies, defined by reference to a certain shareholding spread or that have made an offer to the public.

137. Possible options would be to place the requirement to make continuous disclosure on entities that have issued securities pursuant to an offer to the public, to which the Securities Act 1978 applied. These issuers would already be required to file copies of their financial statements on an annual basis with the Registrar of Companies under the Financial Reporting Act 1993. It could be argued that as there is a certain expectation that some information in relation to these companies will be made public, a more general obligation to disclose on a continuous basis could be imposed. However, there is currently no centralised system for such disclosure.

138. Another option may be to expand the Registrar of Companies' office database to create a disclosure system similar to the Canadian SEDAR system or to require all issuers to whom the law applies to maintain a publicly available internet site.

139. The continuous disclosure requirements in the Australian Corporations Act extend to issuers of "ED Securities", short for "enhanced disclosure securities" – see Corporations Act 2001 s.111AD.

140. Section 111AF(1) of the Corporations Act states that:

> "Securities (except debentures) in a class of securities of a body are ED securities if:
>
> (a) a disclosure document in relation to securities in that class has been lodged with ASIC under Chapter 6D; or
>
> (b) securities in that class have been issued pursuant to the disclosure document; and
>
> (c) after an issue of securities in that class pursuant to the disclosure document, 100 or more persons held securities in that class; and
>
> (d) securities in that class have been held by 100 or more persons at all times since the issue of securities referred to in paragraph (c)."

141. Securities issued as consideration for certain offers in off-market takeover bids, and in certain compromises and arrangements are also ED Securities.

142. Section 674 of the Corporations Act deals with listed securities and provides that:

> Obligation to disclose in accordance with listing rules
>
> (1) Subsection (2) applies to a listed disclosing entity if provisions of the listing rules of a listing market in relation to that entity require the entity to notify the market operator of information about specified events or matters as they arise for the purpose of the operator making that information available to participants in the market.:
>
> (2) If:
>
> (a) this subsection applies to a listed disclosing entity; and

(b) the entity has information that those provisions require the entity to notify to the market operator; and

(c) that information:

(i) is not generally available; and

(ii) is information that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of ED securities of the entity;

the entity must notify the market operator of that information in accordance with those provisions.

143. Section 675 deals with disclosure by unlisted entities and entities that are a listed disclosing entity that does not have listing rules relating to continuous disclosure. Section 675(2) provides that:

(2) If the disclosing entity becomes aware of information:

(a) that is not generally available; and

(b) that a reasonable person would expect, if it were generally available, to have a material effect on the price or value of ED securities of the entity; and

(c) either

(i) if those securities are not managed investment products—the information is not required to be included in a supplementary disclosure document or a replacement disclosure document in relation to the entity; or

(ii) if those securities are managed investment products—the information has not been included in a Product Disclosure Statement, or a Supplementary Product Disclosure Statement, a copy of which has been lodged with ASIC; and

(d) regulations made for the purposes of this paragraph do not provide that disclosure under this section is not required in the circumstances;

the disclosing entity must, as soon as practicable, lodge a document with ASIC containing the information

144. The Financial Services Reform Act 2001 introduced further provisions establishing a regime for ongoing disclosure of information in relation to financial products for which product disclosure is required. Disclosure is required of material changes or significant events that should have been specified in the statement. Disclosure must be made to persons who were “retail persons when they acquired

the product and who should have been given a product disclosure statement for the end product".

Questions for Submissions

17. Should the continuous disclosure regime apply to unlisted issuers? If so, to which unlisted issuers should the requirement apply? How should these unlisted issuers make disclosure?

Application of Market Manipulation Law

145. Options for the type of market manipulation law that we might adopt are discussed in the *Reform of Securities Trading Law: Volume Two: Market Manipulation Law* discussion document.

146. In considering whether or not to introduce market manipulation law, we must also consider to what issuers this law might apply.

147. By definition, market manipulation regulation is aimed at protecting the efficiency and integrity of the market. For more discussion of the rationale behind implementing market manipulation law, see the market manipulation document at paragraphs 46 to 63.

148. For the purposes of the discussion of the application of the market manipulation law, we need to consider which markets the laws should protect. If the laws are considered to be appropriate, then it is logical that they should apply to issuers whose securities are traded in the public market, that is on any stock exchange registered in New Zealand. It is also arguable that they should apply to other similar markets, for example the futures market, which are public markets so the same rationales should apply. Market manipulation might also occur in "wholesale" markets for example the market for bonds or government stock.

149. It could also be argued that the regulation should be extended to the informal market, perhaps by extension to the trading in securities of issuers that have issued securities pursuant to an offer made under the Securities Act 1978, that is, issuers within the meaning of the Financial Reporting Act. There may be a problem with enforcing the law in these more informal markets, as the manipulation would be difficult to identify where there is no centralised market for which there is a record of trades that have occurred. Both disclosure and trading based practices rely on other market participants trading on the basis of misleading information. Such conduct is likely to be undertaken only where there is a centralised price discovery system which records trading prices and volumes and bids and offers placed.

150. It could be argued that the requirements should be extended to all transactions in securities. However, given the private nature of many of these transactions the scope for market manipulation must be less and the means of detecting it very difficult. However, general prohibitions on false or misleading conduct may apply in situations other than trading in financial markets.

151. The Australian Financial Services Reform Act 2001 generally retained the market manipulation provisions of the Corporations Act 2001 in their previous form and extended their scope as appropriate to apply to trading in financial products on a financial market. Provisions which refer to price use the expression the price "for trading in financial products on a financial market". Section 1041H, which gives rise to civil liability, prohibits misleading or deceptive conduct in relation to a financial product or a financial service, so is capable of applying in situations other than trading on a financial market. Section 1041E prohibits false or misleading statements and may also apply in situations other than trading on a financial market. The other provisions generally apply to conduct that affects financial products that are traded on a financial market in Australia.

152. The trend in other jurisdictions is for market manipulation provisions to apply to a wide range of financial products.

153. The United Kingdom market abuse regime is set out in the Financial Services and Markets Act 2000. Market abuse is defined as behaviour which occurs in relation to qualifying investments traded on a prescribed market. Section 118(3) of the Act allows the Treasury to prescribe markets and qualifying investments. At least eight markets have been designated as prescribed markets, including the London Stock Exchange, futures and options exchanges and exchanges for a number of commodities such as metal and petroleum. Investments traded on these markets are designated qualifying investments.

154. The European Council, in its proposal for a directive on insider dealing and market manipulation, states that the proposed regime will apply to any financial instrument, which is defined as:

- Transferable securities;
- Units in collective investment undertakings;
- Money-market instruments;
- Financial-futures contracts, including equivalent cash-settled instruments;
- Forward interest-rate agreements;
- Interest-rate, currency and equity swaps;
- Options to acquire or dispose of any instrument falling in these categories, including equivalent cash-settled instruments. This category includes in particular options on currency and on interest rates; and
- Derivatives on commodities.

155. The United States, on the other hand, has separate market manipulation regimes applying to securities and to commodities and futures contracts. The relevant legislation is the Securities Exchange Act 1934 and the Commodity Exchange Act. These laws are enforced by separate agencies, the Securities Exchange Commission and the Commodity Futures Trading Commission.

Questions for Submissions

18. If you are of the view that further market manipulation provisions should be introduced, to what entities, products and markets should they apply?

19. Should a general prohibition on misleading or deceptive conduct in relation to securities have a wide application? If so, how should it apply?

Please consider the discussion document on Reform of Securities Trading Law: Volume Two: Market Manipulation Law *when considering these questions.*

Part II: Penalties and Remedies

156. An important question when considering the content of an insider trading or market manipulation regime is what penalties should apply for breaches of the provisions. Appropriate and effective penalties that promote deterrence and that are effectively enforced need to be developed. There are two possible types of penalty, civil and criminal, of which either or both may be imposed. There are also possible civil remedies and administrative remedies that remedy breaches of the law, rather than penalise behaviour.

157. There are diverse attitudes to compliance with the law within any society. At one extreme, a person may value the rule of law and their reputation for complying with the law so highly that they will always comply with every law. At the other extreme, a person may place no value on the rule of law or the risk that their reputation might be adversely affected should their offending be subsequently detected. Between those extremes people will attach a greater or lesser weighting on those factors when deciding whether to comply with the law.

158. Whether done consciously or not, all three approaches amount to a cost-benefit analysis. A risk-neutral person will not offend if the expected costs of doing so are no less than the expected benefits. For the first group the benefits of compliance with the law are so high that no cost associated with non-compliance is worth bearing. For the second and third groups their social attitudes towards compliance with the law are largely fixed at any one time. It is the nature and scale of the likely penalties combined with the likelihood of detection and punishment that determines whether there are adequate incentives for them to comply with the law.

159. When it comes to securities law offences, the degree to which general deterrence will be promoted will be affected by whether:

- the evidential burden to prove an offence can be practically met;
- the detection systems are adequate;
- the systemic arrangements and resources of the enforcement agency are adequate; and
- the penalties are sufficiently high to deter the behaviour.

160. This part of this discussion document discusses:

- Criminal penalties
- Civil penalties; and
- Civil remedies.

161. It asks submitters to identify what types of penalties are needed and what level they should be set at to ensure that potential offenders will take into account the damage they may cause when they consider taking actions that may be illegal. When determining the level of fines and civil penalties the factors that need to be

considered for each substantive offence include the potential scale of the illegal gains to the offender or losses to market participants and the likelihood that the conduct will be detected and punished. In addition the harm caused to the market may be taken into account.

Criminal Penalties

162. In criminal proceedings the standard of proof usually required to convict is "beyond reasonable doubt". In civil cases a party succeeds on the "balance of probabilities". Criminalising insider trading, continuous disclosure or market manipulation will necessarily impose a higher standard of proof. Opponents of criminalising insider trading, continuous disclosure and market manipulation argue that proving beyond a reasonable doubt that someone has conducted market manipulation or insider trading activity could be an insurmountable task in an area of the law where the conduct in question is necessarily secret and detection is difficult. For example, proving tipping may be very difficult as the only evidence may be the oral evidence of the parties. Further, the complexity of the justice system itself may make successful prosecutions for insider trading relatively infrequent. Internationally there have been few successful criminal prosecutions for insider trading, continuous disclosure and market manipulation each year.

163. Those that support criminal convictions do so because such convictions are generally regarded as resulting in more "stigma" than an adverse judgement in civil proceedings. The fact that a prosecution is brought may, in itself, have significant reputational effects. The consequences of a conviction may be quite broad-ranging, for instance criminal convictions can result in imprisonment, an inability to obtain a visa to enter a foreign country, to be considered for some kinds of employment or positions, or to take part in the management of a company.

164. The deterrent effect of criminal liability is therefore likely to be more significant than the possibility of a civil action. While insiders may be prepared to risk the consequences of civil liability, they may be less prepared to risk imprisonment and the reputation and other broad-ranging effects of a criminal prosecution or conviction.

165. Many regimes have moved towards adopting regimes that have both civil and criminal penalties (for example the United States and Australia). Under these regimes criminal penalties provide deterrence and the civil penalties provide a recourse for individuals who have suffered loss or where the standard of proof of criminal proceedings is too hard to meet. This dual regime gives some flexibility.

> “The argument for a cogent structure of cumulative sanctions incorporating civil remedies at the base, criminal sanctions at the apex and civil penalties filling the middle ground is compelling.”[15]

166. It has been argued that it is not advisable to only have criminal penalties for breaches of securities law. Because the criminal standard of proof is hard to meet for insider trading, continuous disclosure and market manipulation, there may be a

---

[15] Goldwasser, "CLERP 6- Implications and Ramifications for the Regulation of Australian Financial Markets" *Company and Securities Law Journal* 17 (1997): 210.

risk that few successful actions would be bought. With few successful prosecutions potential insider traders or market manipulators may not be deterred from breaching the law. In addition, it has been argued that it is not advisable to have criminal penalties alone as it denies the individual the opportunity to recover the losses incurred by the breach of the law.

Questions for Submissions

20. Should criminal penalties be introduced for insider trading, continuous disclosure and market manipulation in New Zealand?

21. If criminal penalties should be introduced, do you think that they should replace, or be added to any civil remedies and penalties?

What "Fault" Element Is Required?

167. Generally criminal offences are categorised into three categories:

- *Mens Rea*: those requiring the prosecution to prove elements of intention or fault or recklessness;
- *Strict Liability:* where the prosecution does not need to establish any *mens rea* with respect to the contravention, but it is a defence for the accused to prove total absence of fault on the balance of probabilities; and
- *Absolute Liability:* those of absolute liability, where *mens rea* is not required and there is no absence of fault defence.

168. Unless there is sufficient reason to the contrary, where the offence is for a serious crime, there is a strong presumption that *mens rea* is an essential element and will be implied as an ingredient of the offence. This follows the common law approach to the criminal law that the accused's state of mind is relevant and that their moral position should be taken into account when determining criminal guilt. The usual fault element required is intention or knowledge. These fault elements usually require intentional conduct, with awareness of the essential circumstances and intended or foreseen consequences. Sometimes recklessness can suffice (this usually requires awareness of the risk and the taking of the risk which is unjustifiable under the circumstances). Usually, negligence is not sufficient (a falling short of the standard of care that a reasonable person would expect in the circumstances).

169. Offences of strict or absolute liability are more likely to be considered "public welfare" or "regulatory" offences. For example, a strict liability offence may be created if the offence involves a protection of the public from those undertaking risk-creating activities. The threat of criminal liability supplies the motive for persons in those activities to adopt precautions in order to ensure that mishaps and errors are eliminated. Further, the accused is often best placed to establish absence of fault because of matters primarily within the accused’s knowledge. Absolute liability offences have been the subject of critical comment on the basis that some people

believe that it is completely inappropriate to subject citizens to the criminal process in any circumstance if they can demonstrate absence of fault.

170. More "serious" offences are more likely to be considered to require *mens rea*, as these offences could open the defendant to significant imprisonment or fines and so a higher level of proof is considered necessary.

Insider Trading Offences

171. The possible elements of insider trading provisions are discussed in the Insider Trading discussion paper. This section is relevant to, and should be read in conjunction with, the discussion on knowledge in the *Reform of Securities Trading Law: Volume One: Insider Trading: Fundamental Review* discussion paper. See paragraphs 247 to 278.

172. The mental or fault element for the insider trading offence might relate to:

a. the accused's knowledge of any connection required to be an insider, (e.g. that information came from an insider);

b. the insider's possession of the information;

c. the insider's knowledge that the information is "inside" information; and/or

d. the intention of the insider to trade.

173. The additional mental or fault elements of the tipping offence might relate to the insider's knowledge about the likelihood that the third party will trade.

174. A *mens rea* requirement could apply in two stages: first to the possession of the information; and secondly to the knowledge that the information is "inside information".

175. Where possession is an element of a criminal offence, the relevant provision will often be interpreted to require the accused to have been aware of the relevant thing and to have intended to exercise possession.

176. It may be appropriate to infer or presume awareness of information in particular circumstances. The accused could then have a defence if they could show they were not aware of the information. For example, a director or others involved in the management of an issuer may be presumed to possess information by reason of their position.[16] This could place an evidential burden on the accused that could lead to a finding that the prosecution did not prove the offence beyond reasonable doubt or it could reverse the burden of proof on this point, requiring the accused to prove on a balance of probabilities that they were not aware of the information.

[16] For example, sections 3(2), 3(3), and 3(4) of the Securities Amendment Act 1988 presume certain persons to have information by reason of their position.

177. Under the current provisions of the Securities Amendment Act 1988 it is not necessary to prove that the insider had any knowledge that the information was inside information.[17] If *mens rea* is to be a requirement for an offence of insider trading, then some element of knowledge that the information is inside information may be required. The fault element could be:

- Knowledge: This could require the prosecution to prove actual knowledge, or that the accused ought to have known; or
- Recklessness. Under New Zealand law, the concept of "recklessness" usually has a subjective element, requiring the accused to have a conscious appreciation of the relevant risk, although sometimes awareness of an obvious risk is inferred.

178. The approach taken by a number of jurisdictions on the question of knowledge is discussed in paragraphs 247 to 278 of insider trading discussion paper.

179. The Australian provisions currently require the prosecution to prove that the accused knew or ought reasonably to have known that the information was not generally available and was materially price sensitive (section 1043 Corporations Act 2001).

180. In other jurisdictions, "actual" knowledge must be proved. For example, under section 57 of the United Kingdom Criminal Justice Act 1993, a person has information as an insider "*if and only if, it is, and he knows that it is, inside information, and he has it, and knows that he has it, from an inside source".* The section goes on to specify the circumstances in which a person will have information from an inside source.

181. *Mens rea* may also be relevant to the disclosure of inside information. See paragraphs 226 to 233 of the insider trading discussion paper.

182. Section 9 of the Securities Amendment Act 1988 requires an insider to have knowledge or belief that another person will or is likely to trade.

183. The Australian provisions currently require a person to "know or ought reasonably to know" that another person will trade.

184. Other jurisdictions do not require "knowledge" where disclosure amounts to breach of a fiduciary or like duty.

185. Criminalisation of insider trading brings special considerations. One of the important considerations is whether there should be a distinction between what the prosecution is required to prove in a criminal matter and what is required in a civil

---

[17] Under the current provisions, to be liable, an insider must "have" inside information. The Court of Appeal in *Wilson Neill* [1994] 2NZLR 152, 161 formed the view that the test is not subjective knowledge, but the objective possession of information. It was enough that the relevant insiders had in their possession board papers that contained the relevant information, even though it had not been proved that they had done an analysis of the material. It was not considered necessary to prove knowledge that the information was inside information.

matter. In Australia, the United States and the United Kingdom the legal content of what is required to be proven in a criminal prosecution is different than that required to be shown in a civil case. Aside from a different standard of proof required in a criminal case, it is generally the case that the prosecution will be required to establish additional fault or mental elements in order to prove that an offence has been committed. For example, concepts of dishonesty, intention or purpose. It will be important to consider whether different fault elements should be adopted for criminal and civil proceedings.

Market Manipulation Offences

186. The types of conduct which might be regulated by market manipulation law are discussed in the Market Manipulation discussion paper. The ways in which these activities are regulated in some other jurisdictions are also set out. There are five general categories of proscribed or restricted conduct:

- misleading and deceptive conduct in relation to dealing in securities;
- making false or misleading statements in relation to dealing in securities;
- conduct creating artificial prices;
- fictitious transactions; and
- short selling.

187. If these types of conduct are to be regulated by statute, then we need to consider whether criminal penalties should be imposed, and whether the offences should have an element of *mens rea*. It may be appropriate to make some market manipulation prohibitions criminal offences, for example the specific offences such as conduct creating artifical prices or fictitious transactions. However, it may be appropriate that others such as general prohibitions against false or misleading conduct in relation to securities give rise to civil liability only. A *mens rea* requirement may be appropriate for the former but not the latter.

188. The purpose of market manipulation law is by definition to protect the integrity of the market for securities by prohibiting conduct that is likely to distort prices and other indicators of market activity. Individuals who participate in the market benefit from this protection indirectly. Prohibitions against misleading conduct and making misleading statements may protect individual market participants directly.

189. The actual physical elements or *actus reus* of market manipulation would comprise the particular prohibited conduct and its effect. The *mens rea* element could relate to the person's purpose or intention when engaging in the proscribed conduct, or in the case of misleading statements or conduct, their knowledge or belief of the misleading nature of the statement or conduct. There are a number of ways the law could deal with this.

190. The law could require the accused to have intended the particular effect to be convicted. Another option would be for the law to allow a defence if the accused could show that they did not have the intention to create the necessary effect, or if

they acted for some other purpose. In terms of making false or misleading statements, the law could require that the accused must know that a statement published is misleading, false or deceptive, or must recklessly publish such a statement.

191. The Australian short selling provisions contained in sections 1020B and 1020C of the Corporations Act 2001 have an element of *mens rea.* In order to avoid breaching the provisions, a seller of a security must believe on reasonable grounds that the seller or their principal has a currently exercisable and unconditional right to vest the securities in the buyer.

192. Section 58 of the Securities Act 1978, which provides for a criminal offence for distribution of an advertisement or registered prospectus that includes an untrue statement, gives a defence to persons who can prove that the statement was immaterial, or they had reasonable grounds to believe and did believe that the statement was true. Note that under this section the "materiality" of the untrue statement need not be proved by the prosecution, but must be "disproved" by the accused.

193. The Corporations Act provides a specific due diligence defence for prospectuses. A person will have a defence if they prove they did not know that the statement was misleading or deceptive or did not know that there was an omission. A person will also have a defence if they have place reasonable reliance on information given to them by certain other persons.

Questions for Submission

22. Should an insider trading offence have a *mens rea* requirement, or be an offence of strict or absolute liability?

23. What might a *mens rea* requirement for possession of information be?

24. Can possession be presumed in certain situations?

25. Should there be a requirement for knowledge that the information is price sensitive?

26. Should there be an additional *mens rea* requirement for the tipping offence?

27. Should the *mens rea* requirement be an element of the criminal offence only and not necessary to prove civil liability?

28. Should market manipulation offences have *mens rea* requirements, or be offences of strict or absolute liability?

29. Should the *mens rea* requirements be elements of the offence to be proved by the prosecution, or should they give an accused a defence?

30. Should the *mens rea* requirement be an element of the criminal offence only and not necessary to prove civil liability?

31. Should there be a distinction between what the prosecution has to establish in a

criminal proceeding and a civil proceeding?

Burden and Standard of Proof

194. In any criminal prosecution, the Crown must prove all the elements of the offence beyond a reasonable doubt. Any "defences" that might attack the existence of the *actus reus* or *mens rea* must be negated by the prosecution once an evidential burden to support the defence has been met.

195. Where there is an "exonerating factor" stated in the legislation that alters what would otherwise be a criminal act into a lawful one, this can be characterised as an element of the offence, requiring its negation by the prosecution beyond reasonable doubt. Alternatively, it may be categorised as a "statutory defence" which the accused is required to prove on a balance of probabilities.

196. This categorisation can have a practical difference depending on whether the offence is tried under the Summary Proceedings Act 1957 or as an indictable offence. Under the Summary Proceedings Act, the accused has the burden of proving any statutory exception, exemption, proviso, excuse or qualification, where these are found without further enlargement, on a balance of probabilities. On an indictment, the accused has only an evidential burden to raise the issue of the defence. The prosecution must then negate the defence beyond reasonable doubt. However, this is a general rule only, and does not apply where the statutory provision requires differently. That is, a statute may, expressly, or by implication, place an evidential or persuasive burden on a defendant who wishes to take an advantage of a defence, even where the offence is tried on indictment.

Insider Trading Offences

197. If we make insider trading a criminal offence, then we need to consider whether the Crown must negate any defences, or whether these must be proved by the accused.

198. Professor Tomasic has suggested that the onus of proof should be reversed for insider trading on the grounds that “the matters raised by way of defence are usually peculiarly within the knowledge of the accused”; and that “spurious propositions” may be advanced by the defence which almost any amount of prosecutorial resources will not be able to negate.”[18]

199. However, it has also been argued this suggestion should be treated with scepticism as it should not be assumed either that theories advanced by the prosecution are well founded, or that explanations offered by defendants are necessarily untruthful.[19]

---

[18] R Tomasic and B Pentony, "The Prosecution of Insider Trading: Obstacles to Enforcement" aust abd *New Zealand Journal of Criminology* 22 (1989): 136.

[19] Ashley Black, "The Reform of Insider Trading Law," *UNSW Law Journal* 15, no. 1: 250.

200. The defences provided in law to a charge of insider trading will depend on how wide the offence is cast. A number of possible defences are discussed in the *Reform of Securities Trading Law: Volume One: Insider Trading: Fundamental Review* discussion paper in paragraphs 279 to 324. These include:

- Buybacks;
- Underwriting;
- Acquisitions pursuant to a legal requirement;
- Information communicated pursuant to a legal requirement;
- Chinese walls;
- Knowledge of own intention;
- Takeovers -
    - due diligence
    - white knights;
- Procedures to allow trading by company insiders; and
- Equal information.

201. Other aspects of the offence could amount to "defences" for example:

- Non-use of inside information in trading;
- Trading contrary to inside information;
- Lack of possession of inside information in situations where possession is presumed; and
- Lack of knowledge that information is inside information in situations where knowledge is presumed.

Market Manipulation Offences

202. If we introduce market manipulation offences into the law we must consider which elements must be proved by the prosecution beyond reasonable doubt and which defences must be negated by the prosecution or proved by the accused.

203. The law could require all the elements of the offence to be proved by the prosecution. Alternatively, some elements of the offences could be presumed and be rebuttable by the accused.

204. See the discussion above at paragraphs 186 to 194 concerning possible *mens rea* elements of market manipulation offences. See also Part IV of the *Reform of*

Securities Trading Law: Volume Two: Market Manipulation Law discussion document.

Questions for Submission

32. What defences to insider trading should the Crown have to negate beyond reasonable doubt? For what defences must the accused bear the burden of proof on the balance of probabilities?

33. What defences should there be to market manipulation offences?

34. Should the market manipulation law require the defences to be negated by the prosecution, or proved by the accused?

Which State Agency Should Be Responsible for Investigating and Prosecuting Criminal Offences?

205. If a decision is taken to introduce criminal offences for breaches of insider trading, continuous disclosure and market manipulation law, then an appropriate body must be identified to undertake investigation and prosecution on behalf of the State.

206. Any organisation which undertakes such investigations and prosecutions will need to be a specialist body with appropriate powers and expertise. Further, the organisation will require appropriate working and information sharing relationships with stock exchanges, as well as regulators and market operators offshore. The following agencies are considered:

- The Securities Commission;
- The Registrar of Companies; and
- The Serious Fraud Office.

The Securities Commission

207. The Government has announced an intention to make the Securities Commission a civil enforcement body for insider trading. The Securities Markets and Institutions Bill, which is currently before Select Committee, proposes to give the Commission this role for insider trading. This legislation also proposes new inspection powers for the Commission and powers that will enable it to carry out this role effectively.

208. The Commission's past experience with insider trading inquiries, its proposed new civil enforcement role and the new powers the Commission will receive mean that the Commission will have experience investigating insider trading activity and may be best placed to identify when a criminal action should be taken. Further, the Commission has the appropriate working and information sharing relationships with stock exchanges and market operators and regulators offshore.

209. This, it may be argued, makes it appropriate to give the Commission a criminal enforcement role either in investigating criminal breaches or taking actions itself.

210. In Australia, the Australian Securities and Investments Commission is responsible for investigating all civil and criminal breaches of the insider trading laws. ASIC has powers which enable it to bring civil proceedings. However, the decision to take criminal proceedings in particular cases is taken by the Office of the Commonwealth Director of Public Prosecutions.

211. Such a structure could be implemented in New Zealand with the Commission investigating criminal breaches and another body with more experience in conducting criminal proceedings taking the prosecution. For such a structure to work the Commission would have to have adequate powers of investigation and appropriate information sharing arrangements with the prosecutor.

Serious Fraud Office

212. The Serious Fraud Office has investigators, forensic accountants and prosecutors who carry out investigations of potential criminal offences and present cases before a court.

213. The Serious Fraud Office Act 1990 gives the Serious Fraud Office extensive powers which it is able to use in cases where serious or complex fraud is suspected. These powers include the:

- Power to require production of documents;
- Power to obtain search warrants; and
- Power to require attendance before director, production of documents, etc.

214. The Act also provides that the privilege of self incrimination cannot be claimed as a reason for not answering questions or providing information or documents where these are required under these powers.

215. The involvement of the Serious Fraud Office in prosecuting insider trading offences would enable the utilisation of existing expertise in a specialist body with experience of exercising the types of powers which would be required for the detection and investigation of insider trading and market manipulation offences.

Registrar of Companies

216. The Registrar of Companies is responsible for the Companies Office, which maintains the registry for all corporate bodies in New Zealand.

217. The Securities and Corporate Compliance Unit of the Companies Office undertakes some market enforcement through the analysis and vetting of financial reports, investment prospectuses and other information disclosed under the Securities Act, Financial Reporting Act and related legislation. Where issues of statutory non-compliance arise the Unit has the power to investigate cases and may

pursue civil or criminal sanctions. The Registrar has investigating accountants and solicitors who carry out this enforcement work.

218. The Registrar has powers of inspection which are able to be used for detecting offences under the Companies Act 1993 or the Financial Reporting Act 1993. These powers enable the Registrar to require the production of documents, to inspect and take copies of documents and to retain documents if there are reasonable grounds for believing that they are evidence that an offence has been committed. The Registrar also has powers of inspection under the Securities Act 1978 and Takeovers Act 1993 which may only be exercised with the request of the Securities Commission.

219. There may be benefits from using the same body to carry out prosecutions under a range of related legislation. The Registrar already deals with offences under the Securities, Companies and Financial Reporting Acts. On the other hand, insider trading and market manipulation may be more similar to the features of "serious fraud" because of their secretive nature and associated problems of detection. The Serious Fraud Office has the role and associated expertise to investigate serious fraud offences.

Questions for Submissions

35. Which body or bodies should have responsibility for investigating and/or prosecuting offences for insider trading?

36. If the Serious Fraud Office or the Registrar of Companies were empowered to take criminal actions, what, if any, role should the Commission play?

Protections for the Accused in Criminal Trials

220. There are significant differences in the law relating to the prosecution of civil wrongs and criminal offences. These arise because criminal offences are almost always prosecuted by the state, whereas private individuals enforce civil wrongs. Greater protections for the accused are provided in the criminal law context to balance the usually superior resources of the state, and also to guard against unjustified intrusion into individuals affairs by the state.

221. The main difference between a civil and criminal prosecution will be the standard of proof that the plaintiff and the Crown, as the case may be, must meet in order to secure a judgement or conviction. In the former, the plaintiff must prove the case on the balance of probabilities, in the latter the Crown must prove the case "beyond reasonable doubt". As a result, it will be more difficult for the Crown to prove a criminal offence has been committed.

222. Another fundamental difference between a criminal and civil prosecution is that in the former the accused has an absolute right to silence, whereas any person is compellable as a witness in civil proceedings. However, if an accused chooses to give evidence, then they must answer all questions notwithstanding that they may

incriminate themselves. In civil proceedings, witnesses can refuse to answer questions on the grounds that they would incriminate themselves.

223. If criminal liability is to be imposed for insider trading, market manipulation, and continuous disclosure, then we must consider how the law relating to self-incrimination is to apply. This is also important if the Securities Commission is to have a role in taking civil action in these areas and if a civil penalties regime is to be introduced.

224. Under current New Zealand law, a person claiming the privilege against self-incrimination may refuse to answer questions or give information that would expose the person to risk of a criminal charge, put the person in danger of a civil penalty or that might lead to a forfeiture. The privilege can be claimed by individuals and corporations. It applies to oral testimony. The privilege can also be claimed for the content of documents, except where the contents can be proved by independent means. In some cases, the privilege has been held to extend to the compelled production of real evidence.

225. The privilege can be claimed by witnesses in civil and criminal proceedings. However, the accused in a criminal trial who chooses to give evidence cannot claim the privilege in response to questions relating to the charges that are the subject of the proceedings.[20]

226. The privilege can be preserved or removed by legislation, in the context of information gathering powers conferred on state agencies.

227. Because the privilege can be claimed on the basis that providing the information may lead to the imposition of a penalty, it is arguable that a person could claim the privilege for information that might lead to the imposition of a pecuniary penalty under Part I of the Securities Amendment Act 1988. However, there is no judicial authority on this point.

228. The circumstances when a person would be most likely to claim the privilege is on being summoned by the Securities Commission to give evidence or produce documents under section 18(3) of the Securities Act 1978. The Commission has used this power frequently for the purposes of inquiries it has made into insider trading. The privilege is not specifically mentioned in the statute. Under section 32 it is an offence to refuse or wilfully neglect to appear before the Commission in pursuance of a summons or to answer any question or provide any document required to be produced. Whether the privilege is preserved, has never been tested in Court. In the absence of an express provision removing the privilege it is likely that the privilege can be claimed in response to a summons under section 18.

229. It seems that when individuals claim the privilege, the Securities Commission usually makes confidentiality orders under section 19(5)(b) of the Securities Act.[21]

---

[20] Section 5(4)(a) Evidence Act 1908.

[21] The description of the Securities Commission's practise and experience in this area is taken from the Law Commission's Preliminary Paper 25. *The Privilege against Self-Incrimination*, paras 372-379.

Orders under this section can prevent the publication or communication of any information document or other evidence until the determination of the inquiry. On the basis of these orders, the privilege is usually waived.

230. Once the Commission's inquiry has been completed, the information subject of the confidentiality order can be obtained under the Official Information Act 1982 unless there are reasons for not releasing the information under that Act. Furthermore, some information can be obtained by non-party discovery in proceedings brought for breach of Part I of the Securities Amendment Act.[22]

231. The Securities Markets and Institutions Bill contains amendments that will provide that testimony given before the Commission will not be admissible in criminal proceedings (other than a proceeding in respect of the falsity of the testimony, e.g. perjury or an offence for false statements under the Act).

232. The Law Commission has proposed reform of the privilege against self-incrimination in its Report 55. Under the provisions of the Law Commission's proposed Evidence Code, the privilege will be restricted and only be available to individuals (not corporations) to resist compulsory disclosure of information that, if disclosed, would expose him or her to the risk of prosecution for an offence punishable by imprisonment. It would not be enough if the information would expose the person to a civil penalty. The privilege will not be available to the accused in a criminal trial who chooses to give evidence in relation to information about a matter to which the accused is being tried.

233. "Information" in this context is defined to mean a statement of fact or opinion which is given, or is to be given orally, or newly created documents admitted as testimonial statements rather than exhibits. Thus real evidence admitted as an object rather than as a statement and all documents existing prior to the request to produce the information cannot be withheld by claiming the privilege.

234. The accused retains a right to silence at criminal trial. The suspect could claim the privilege at the investigative stage, and in respect of information that may incriminate him or her in relation to an offence other than the one for which he or she is being tried.

235. The privilege would be able to be removed explicitly by statute.

236. Where a person volunteers self-incriminating evidence in Court proceedings, a certification procedure would ensure that the information given and any evidence obtained as a result, cannot be used against that person in any other proceedings in New Zealand.

237. The Ministry of Justice is currently considering the Law Commission's Report and draft Evidence Code.

238. If the Serious Fraud Office is to be the state organisation to be given the task of prosecuting insider trading offences, then its powers of information gathering will be

---

[22] *Franks v Hoggard* (2001) 9 NZCLC, 262, 530.

available. The Serious Fraud Office Act 1990 removes the privilege and replaces it with a partial use immunity for oral disclosures. Oral disclosures made prior to trial cannot be used, except where the person gives inconsistent evidence.[23]

239. In Australia, ASIC has a role to investigate where it has reason to suspect there has been a contravention of the Corporations Act.[24]

240. ASIC has powers to require the production of records and to require individuals to answer questions.[25] A person cannot refuse to give information, sign a record or produce a book if required to do so on the grounds that to do so might tend to incriminate the person or make the person liable to a penalty. However, if a natural person claims the privilege before making an oral statement, giving information or signing a record, that statement or record is not admissible in evidence against the person in a criminal proceeding or a proceeding for the imposition of a penalty except in proceedings relating to the falsity of the statement.[26] The privilege cannot be claimed in respect of the production of books. The evidence may be used against that person in a civil proceeding.

241. The Corporations Act also allows ASIC to seek pecuniary penalties for breach of certain provisions of the Corporations Act 2001.[27] Under current proposals, ASIC will be able to seek pecuniary penalties for breach of insider trading law and market misconduct law. The procedures for these proceedings are a hybrid of civil and criminal law. The Corporations Act provides for civil procedures and rules of evidence,[28] and requires the matter to be proved "on a balance of probabilities".[29]

242. Information given by an individual in a civil case for a civil penalty or pecuniary penalty order is not admissible against that individual in a criminal case. However, the evidence can be used in criminal proceedings in respect of the falsity of the evidence given by the individual in those proceedings.[30]

243. The Commission has the power to require certain persons to assist in the prosecution.[31] Bodies Corporate cannot claim the privilege against self incrimination in criminal proceedings.[32]

---

[23] The Law Commission Preliminary Paper 25 considers the provision in the Serious Fraud Office Act 1990 relating to the privilege against self incrimination.

[24] Section 13 Australian Securities and Investments Commission Act 1989.

[25] Part 3, Division 2 Australian Securities and Investments Commission Act.

[26] Section 68 Australian Securities and Investments Commission Act 1989

[27] Section 1317E Corporations Act 2001.

[28] Section 1317L Corporations Act 2001.

[29] Section 1332 Corporations Act 2001.

[30] Section 1317Q Corporations Act 2001.

[31] Section 1317Corporation Act 2001.

Questions for Submission

37. In light of your previous answers on which body would be the appropriate investigating and prosecuting authority, do any changes need to be made to that authority in relation to the privilege against self-incrimination?

38. Should the Law Commission's recommendations for the law relating to the privilege against self-incrimination be adopted for civil and criminal proceedings for insider trading, market manipulation and continuous disclosure?

39. If insider trading attracts a civil pecuniary penalty should the privilege extend to information that may render the person liable to a civil pecuniary penalty?

Level of Criminal Penalties

244. If we are to make breaches of insider trading and/or market manipulation criminal offences, we need to consider what penalties are appropriate. Related issues are whether the charges could or should be laid summarily or indictably, should the matter be tried in the District Court or the High Court, and whether trial should be before a judge alone, or before a judge and jury.

245. Under New Zealand law there are currently six categories of offences in respect of which charges can be laid:[33]

- Purely indictable offences that can only be tried in the High Court, such as treason, murder and manslaughter;
- Purely indictable offences that may be transferred to a District Court from the High Court pursuant to section 168AA(2) of the Summary Proceedings Act 1957 – these are also known as the "middle band" offences. These offences are listed in Part II of Schedule 1A to the District Courts Act 1947;
- Purely indictable offences that can be tried before a jury in the District Courts. These offences are listed in Part I of Schedule 1A to the District Courts Act 1947;
- Indictable offences triable summarily, which are listed in section 6(2) and the First Schedule to the Summary Proceedings Act 1957;
- Summary-indictable offences, which are summary offences punishable by more than three months imprisonment; accordingly the defendant can elect for trial by jury pursuant to section 66 of the Summary Proceedings Act 1957; and

---

[32] Section 1316A Corporations Act 2001.

[33] Excluding minor offences and infringements. New Zealand Law Commission, *Simplification of Criminal Procedure* January 2001 NZLC SP7. The Law Commission makes various proposals in this advisory report to avoid the complexities of the current legislation.

- Purely summary offences, which have a maximum sentence of three months imprisonment or less. Most of these offences are listed in the Summary Offences Act 1981.

246. This table shows how comparable offences fit within these categories and what their penalties are.

Category	**Relevant Offences**	**Penalty**
"Middle Band" Offences	Mis-statement in advertisement or registered prospectus. Section 58 Securities Act 1978	On conviction on indictment, maximum 5 years imprisonment or $25,000 fine.[34] *NB The Securities Markets and Institutions Bill contains amendments to increase this fine to $300,000.*
Indictable offences triable summarily	Conspiracy to defraud - section 257 Crimes Act 1961	Maximum 5 years imprisonment
	Making false statement in certain documents – section 41(1) Financial Reporting Act 1993	Maximum 5 years imprisonment or $200,000 fine
	Omission from or making a false or misleading statement in a disclosure statement - section 89 Reserve Bank of New Zealand Act 1989	Individuals – maximum 3 years imprisonment or $25,000 fine. Registered Banks – maximum $100,000 fine
Summary Indictable Offences	Carrying on business dealing in futures contrary to section 38 – section 39 Securities Amendment Act 1988.	Individual – maximum 3 years imprisonment and $100,000 fine, or both. Corporation – maximum $300,000 fine.
Purely summary offences	Offering etc in contravention of Act - section 59 Securities Act 1978	Maximum fine $15,000 *NB The Securities Markets and Institutions Bill contains amendments to increase this fine to $300,000.*

[34] Summary proceeding in respect of an offence under section 58 can also be brought.

	Mis-statement in advertisement or registered prospectus. Section 58 Securities Act 1978	On summary conviction, maximum 3 months imprisonment or $15,000 fine. *NB The Securities Markets and Institutions Bill contains amendments to increase this fine to $300,000.*
	Other Offences – section 60 Securities Act 1978	Maximum fine $1,000 or $10,000 depending on the offence. *NB The Securities Markets and Institutions Bill contains amendments to increase this fine to $5,000 or $300,000 depending on the offence.*
	Sections 36, 37, 38 and 39 Financial Reporting Act 1993.	Maximum fines from $10,000 to $100,000
	Companies Act 1993 – offences listed in section 373(1)	Maximum $5,000 fine
	Offences listed in section 373(2)	Maximum $10,000 fine

247. If a defendant is to have the right to elect trial by judge-alone or jury, the offence will have a maximum penalty of more than three months imprisonment, or be listed in the First Schedule of the Summary Proceeding Act. If the offence is considered "serious" so it must be considered in the High Court, then it would be included in the "middle band" of offences. This would give the High Court jurisdiction to try more serious cases and to transfer others to the District Court. Unless the maximum fine is specified, section 7 of the Summary Proceedings Act will limit the fine to a maximum of $10,000.

Questions for Submission

40. What penalties should be imposed for criminal offences for breach of:

- insider trading law;
- continuous disclosure; and
- market manipulation law.

41. Should the High Court or District Court have jurisdiction to hear insider trading, continuous disclosure or market manipulation charges?

42. Should the accused in an insider trading trial, continuous disclosure trial or market manipulation trial have a right to be tried by jury?

Civil Remedies

Who Should Have a Private Cause of Action for Breaches of Insider Trading Laws?

248. The policy justifications behind an insider trading regime are also important when considering the appropriate penalties or remedies that should be implemented. Civil remedies connected to loss may be considered a more appropriate remedy for an insider trading regime based on the fiduciary duty or misappropriation rationales, while civil or criminal penalties may be more appropriate for the market efficiency or fairness rationales, as they focus on wrong to the market rather than the individual.

249. Overseas and New Zealand experience suggests that private enforcement of insider trading prohibitions is not an effective means of deterrence. The effort required in detecting and proving breaches of the prohibitions means that private actions are only likely in very serious cases where public action is not being taken. However, it seems generally accepted that a counter-party to a trade with an insider should have a cause of action.

250. Under current law the counter-party to a transaction with an insider has a cause of action against the insider. Under section 18 of the Securities Amendment Act, the Court may also give leave to a member of the public issuer or a person who was a member of the public issuer at the time the securities were sold or purchased to bring a derivative action. Australian law also gives the counter-party a right to bring an action.[35]

251. Where the relevant transaction takes place off market, it may be easy for a plaintiff to show a sale or purchase to which the plaintiff is a party. In *Wilson Neill*[36] Cooke P stated that beneficial ownership would appear to be enough to attract the obligations of a seller under the legislation. This case indicates that the courts may be willing to take a wide view of what constitutes a "sale" or "purchase", but where

---

[35] Section 1043L Corporations Act 2001.

[36] [1994] 2 NZLR, 152, 162.

the insider has sold on market it may be more difficult to prove the necessary connection. There may be no direct contractual nexus between the insider and the ultimate purchaser. Both may have transacted through members of the New Zealand Stock Exchange who will have acted as principals in the transaction.

252. There may be a practical problem in determining the identities of those who were indirect counter-parties to the insider's sale or purchase. There may be a number of counter-parties if a large number of securities are purchased or sold by the insider. Where there has been active trading in the securities there may have been other contemporaneous trades at a similar price with non-insiders.

253. Current law gives a direct cause of action only to the direct counter-party. Other contemporaneous traders must use the right to take derivative action under section 18 if they are a member of the issuer, or were a member at the time of the transaction. Contemporaneous traders may benefit under section 18 from action taken by or in the name of the issuer. However, section 19 contemplates a judgement being obtained. Where the proceedings are settled without court involvement, contemporaneous traders may not receive any compensation.

254. It could be argued that a wider class of counter-parties should have a direct cause of action. In the United States and Singapore, contemporaneous traders have a cause of action. Under Singapore provisions the court can consider a number of factors in determining whether contemporaneous trading has occurred. These include:

- the volume of the relevant securities or other financial products traded between the date and time of the contravention and the date and time of the alleged contemporaneous trading;
- the date and time of the contravention;
- whether the alleged contemporaneous trading took place before or after the contravention;
- whether the alleged contemporaneous trading took place before or after the information that relates to the inside dealing became generally known; and
- such other factors and developments, whether in Singapore or otherwise, as the court may consider relevant.

255. By contrast the United States legislation does not define what contemporaneous trading is. This has been left to the Courts to determine.

Questions for Submission

43. Should the law allow direct counter parties to trades with insiders a cause of action against an insider trader?

44. Should the law allow contemporaneous traders a direct cause of action against an insider trader? If so, how should the concept of contemporaneous trading be defined?

The Public Issuer

256. Under the Securities Amendment Act 1988, the public issuer of which the insider is an insider has a cause of action. This right may, with the leave of the court, be exercised by a member of the public issuer or a person who was a member at the time of the transaction.[37]

257. Section 17 of the Securities Amendment Act allows a member person who was a member at the time of the trade to require the issuer to obtain a legal opinion as to whether the issuer has a cause of action against an insider.

258. The Securities Markets and Institutions Bill proposes to give the Securities Commission the power to bring a civil action under Part I of the Securities Amendment Act 1988 if it considers it is in the public interest to do so. Where a proceeding was commenced or continued by the Commission the Commissions costs will be paid out from the amount recovered.

259. In practice the right of the public issuer to bring an action may not be a significant deterrent to insider trading. Exercise by the issuer of this right may be unlikely for a number of reasons. The insider may be in a position of influence within the issuer. In addition, except where the issuer is a counter-party, there is arguably no loss for the issuer to be compensated. Any harm will be caused to the counter-parties or the market in general. New Zealand law deals with this point under section 19 by requiring the public issuer to distribute any proceeds in accordance with the directions of the court.

260. The right of the public issuer to take action can be justified as a response to a breach of fiduciary duty to the issuer, or misappropriation of proprietary information.

261. Australian law gives the issuer a cause of action[38] but does not require it to distribute the proceeds. The ASIC has the power to bring a civil action in the name of the issuer to recover amounts the issuer is entitled to recover under the legislation.[39] The Company and Securities Advisory Committee has suggested that a provision similar to section 19 of the Securities Amendment Act 1988 requiring distribution of proceeds recovered by an issuer be introduced into Australian law.

262. It could be argued that the problems associated with an issuer's cause of action can be overcome by allowing derivative actions by shareholders under section 18 of the Securities Amendment Act 1988. However, this provision may not be used where the Securities Commission has a role to bring civil actions and if contemporaneous traders are given a cause of action. It could also be argued that a right for the issuer to bring proceedings is not necessary if the Commission is given

---

[37] Section 18 Securities Amendment Act 1988.

[38] Section 1043L Corporations Act 2001.

[39] Section 1043L Corporations Act 2001.

the task of bringing civil actions, and may cause confusion as to which body should or will bring an action.

Questions for Submission

45. Should the issuer have a cause of action against an insider trader? Should the derivative action by members be retained?

Market Manipulation

263. The theoretical basis for regulation of market manipulation is that the prohibited conduct harms the efficiency and integrity of the market. It could be argued that only state enforcement of these laws is appropriate in the public good.

264. The counter argument is that the identity of the party taking the action is not the key issue. What matters is whether enforcement, whether public or private, will usefully contribute to deterring illegal conduct. Private enforcement could make such a contribution if a person can prove that they have suffered loss by reason of breach of market manipulation laws and has a cause of action against a person who has breached the law.

265. New Zealand law provides for compensation for loss in securities related areas under the Fair Trading Act 1986,[40] the Securities Act 1978 in relation to public offers of securities[41] and the Securities Amendment Act 1988 in relation to insider trading and substantial security holder disclosure.[42]

266. Australian law provides for compensation for loss for breach of the market misconduct provisions.[43]

Questions for Submissions

46. Should persons who have suffered loss caused by actions that breached the market manipulation provisions be able to bring civil action for damages?

Calculating Damages for Loss

267. Damages for loss may not be an effective deterrent to insider trading or market manipulation if all that the insider or manipulator may lose are the "illegal profits". However, where there is a counter-party loss in relation to an insider trade or caused

---

[40] Section 43 Fair Trading Act 1986.

[41] Section 56 Securities Act 1978.

[42] Part I and section 32 Securities Amendment Act 1988.

[43] Section 1005 Corporations Act 2001.

by market manipulation, then damages for loss may be appropriate as a means of compensation.

268. Currently our insider trading law determines the loss avoided or the gain made as to the difference between the consideration and the value of the security had the inside information been available (section 15). The section seems to require an objective assessment of the value of the security at the time of the trade, but does not specifically require consideration of other information which might affect the price but which had not been disclosed at the time. For example, if the release of the inside information would depress the price of the securities, but there was other non-public price sensitive information unknown to the insider, the release of which would increase the price, then the insider may not have avoided any loss by selling the securities.

269. Under section 149 of the Companies Act 1993 which restricts share dealing by directors of companies, a "fair value" test is adopted. Fair value is to be determined on the basis of all information known to the director or publicly available at that time. This definition arguably does not allow consideration of information unknown to the director and not publicly disclosed.

270. Under Australian insider trading law, the test is the difference between the cost of the securities and the price at which they would have been likely to have bought or sold or subscribed if the information had been generally available (Section 1013 Corporations Act). Under the market manipulation provisions the test for loss is the difference between the price at which the securities were dealt in in that transaction and the price at which they would have been likely to have been dealt in in such a transaction when the first-mentioned transaction took place of the breach had not occurred (section 1014 Corporations Act).

271. Canadian insider trading legislation uses an "average market price" formula to determine the measure of damage suffered by the counterparty where the affected securities are publicly traded. In determining the amount of damages the Court may consider the difference between the price paid or received and the average market price in the 20 days following general disclosure of the information.

272. In the United States, the Court will calculate the difference between the price paid or received by the insider and the trading price of those securities within a reasonable time after public dissemination of the information. The rationale is that the insider is free to enter the market after the information is released and any profit or loss occurring after that point is not unjustly obtained.

Questions for Submissions

47. Should the law provide guidance to assist in calculating the damage caused by insider trading or market manipulation? If so, what indicators should be used?

Civil Pecuniary Penalties

273. Pecuniary penalties for breach of the insider trading prohibitions can be obtained by a public issuer under Part I of the Securities Amendment Act 1988. These could be sought by a member or former member when taking a derivative action in the name of the issuer. If the proposals to give the Securities Commission the ability to take an action are adopted, then the Commission could also seek a pecuniary penalty.

274. The pecuniary penalty obtainable under the Securities Amendment Act 1988 is three times the amount of the gain made or the loss avoided by the insider in buying or selling the securities, whichever is greater.[44]

275. The Australian regime also has civil penalties however, these are not connected to the gain made or the loss avoided. These civil penalties for market misconduct, continuous disclosure and insider trading provisions have been introduced by the Financial Services Reform Act 2001.

276. The provisions empower a court to make various civil orders including:

- a declaration of contravention;
- a pecuniary penalty order of up to $200,000;[45] or
- a compensation order for the corporation or registered scheme which has suffered damage through a contravention.[46]

277. A breach of a civil penalty provision is not, without more, a crime. This requires proof of additional mental (or fault) elements.

278. Penalties can be imposed by a court upon application of the Australian and Securities Investment Commission (section 1317). The court "must apply the rules of evidence and procedure for civil matters" and a civil penalty order can only be imposed if the contravention:

- materially prejudices the interests of acquirers or disposers of the relevant financial products; or
- materially prejudices the issuer of the relevant financial products, or if the issuer is a corporation or a scheme, the members of that corporation or scheme; or
- is serious.

---

[44] Sections 7(4), 9(4), 11(4), 13(4).

[45] Section 1317G Corporations Act 2001.

[46] Section 1317H Corporations Act 2001.

279. When the civil penalty provisions were first introduced, the bringing of a civil penalty action precluded criminal action. Subsequently, the Corporations Act was amended so that a criminal action would not be barred by bringing a civil penalty action.[47] However, civil penalty proceedings against a person must be stayed if a person has been charged with a criminal offence in relation to the same conduct,[48] but may be resumed if there is no conviction. If there is a conviction, the civil proceedings must be discharged. Civil penalties cannot be imposed in respect of conduct for which a person has been convicted of an offence.[49]

280. Civil penalties can be recovered for breaches of the insider trading and market manipulation provisions and for breaches of the continuous disclosure regime.[50]

281. There has been criticism of these provisions for a number of reasons. First, the maximum amount obtainable is $200,000. This it has been argued may not provide a significant deterrent. Further, it has been argued that there should be no middle ground between civil and criminal remedies. The argument is that there is a fundamental distinction between the purposes of the criminal law, and the procedure by which it achieves its objectives, on the one hand and the compensatory functions of the civil remedies and the procedures by which that objective is achieved on the other. This view holds that it is an inappropriate function of a court exercising a civil jurisdiction to be given the power to impose punishment, without the procedural and other safeguards of the criminal justice system.

282. However, the argument for a similar civil penalties regime to that in Australia is that it provides a "middle ground" between private civil action and criminal prosecution for enforcement of the law. It provides for State enforcement, but in the civil courts, with the standard of proof on the balance of probabilities instead of the criminal standard of "beyond reasonable doubt". It also deals with the issue that counter-parties (people that have suffered loss) are often difficult to identify. Further, it may be difficult to calculate compensation for a wrong which has harmed the market as a whole, particularly when, for example, the insiders profit may be relatively small, not otherwise justifying commencement of a civil action to recover. This, it is contended, makes enforcement easier.

283. Civil penalties are awarded in the New Zealand context. Examples in the Commerce Act 1986 include:

- Under section 83 the Court may award a pecuniary penalty not exceeding $500,000 in the case of a person and $5,000,000 in the case of a body corporate for breaches of the business acquisition provisions;

---

[47] Section 1317 P Corporations Act 2001. Goldwasser, "CLERP 6- Implications and Ramifications for the Regulation of Australian Financial Markets", 206.

[48] Section 1317N Corporations Act 2001.

[49] Section 1317M Corporations Act 2001.

[50] Section 1317P Corporations Act 2001.

- Under section 74D the Court can award a pecuniary penalty not exceeding $500,000 for contravention of a cease and desist order; and

- Under section 80 a penalty not exceeding $500,000 for an individual and either a sum not exceeding $10,000 or 3 times the value of the commercial gain or 10% of the body corporate and all inter-connected body corporates turnover for a contravention of the restrictive trade and practices provisions.

Administrative Financial Penalties

284. The United Kingdom has given its securities regulator, the Financial Services Authority, the power to impose financial administrative penalties. The grounds for imposing these financial penalties are designed to reflect market behaviour and expectations. The tests employed are different from those that impose criminal liability. The four requisites for administrative penalties are:

- The person must possess information that is not generally available to the market at large;

- The information would be likely to be regarded by a regular user in the market as relevant when deciding the terms on which transactions in investments of the kind in question should be effected;

- The information must relate to matters which a regular user would reasonably expect to be disclosed to other users of the market on an equal basis, whether at the time in question or in the future;

- The person's behaviour must be based on the information, and not be required for other reasons.

Questions for Submission

48. Should New Zealand have a civil penalties regime for insider trading, market manipulation and continuous disclosure like that in Australia?

49. If so, what should the maximum penalty be?

50. How should criminal prosecutions and civil penalty proceedings interrelate?

51. Should the Securities Commission be given the power to impose financial administrative penalties?

Remedial Orders

285. There may be other remedial or punitive orders that could be made by a court for breach of the insider trading law, continuous disclosure or market manipulation law.

286. The following are examples of orders that may be appropriate:

- declaring the exercise of any rights attached to any securities to be void and of no effect;
- restraining the exercise of rights attached to any securities;
- restraining the acquisition or disposal of securities;
- directing the disposal of securities or any relevant interest in them;
- directing the forfeiture of securities;
- vesting securities in a person as trustee to be dealt with as ordered;
- restraining engaging in conduct that would breach the law;
- cancelling an agreement for the acquisition or disposal of securities;
- directing a person to do or refrain from doing a specified act;
- declaring the whole or any part of a relevant contract to be void or void *ab initio*;
- varying a contract or arrangement;
- directing a person to refund money or return property to a person who suffered the loss or damage;
- directing a person to pay to a person who suffered loss or damage the amount of the loss or damage;
- refusing to enforce any or all of the provisions of a contract;
- prohibiting a person from being a director or promoter of a company or being concerned in the management of a company;
- cancelling a licence issued under the Sharebrokers Act 1908; and
- directing a person to pay the Commission's costs of bringing an application.

287. The above are examples or orders that are available under the Securities Amendment Act 1988 in relation to substantial security holders, the Takeovers Act 1993 and the Australian Corporations Act 2001.

288. They may not all be appropriate for breaches of insider trading law, continuous disclosure law and market manipulation law. However, it may be appropriate to give the court flexibility to make orders that suit the particular circumstances.

289. It may also be advisable to give the Securities Commission the ability to make an application to the court for any of the orders that can be awarded for a breach of the insider trading and market manipulation provisions. This is because the Commission will be investigating infringements and will be the body best placed to identify when a contravention of the law has occurred.

290. When these orders should be available will also need to be considered. Orders could be given at the court's discretion, where there are reasonable grounds to believe certain matters have occurred, or where there are reasonable grounds to believe such orders may be necessary to prevent an undesirable market situation.

Questions for Submission

52. Do you think a court should be able to make a wide range of orders for breach of insider trading law, continuous disclosure law and market manipulation law? What orders would be appropriate?

53. Do you think that the Securities Commission should be given the ability to apply to the Court for any of the orders that the court can give?

54. When should the orders be made available?

Bounties

291. In the United States the Securities and Exchange Commission has been empowered to award a bounty to a person who provides information leading to the recovery of a civil penalty from an insider trader, from a person who "tipped" information to an insider trader or from a person who directly or indirectly controlled an inside trade.

292. The Commission may award bounties from the civil penalties that are actually recovered from violators. The total amount of bounties that may be paid from a civil penalty may not exceed 10% of that penalty.

293. The SEC does not disclose the identity of the confidential source unless the disclosure is legally required, or will be essential for the protection of the public interest.

294. An ability to pay bounties may provide a tool to overcome the perceived problem of obtaining information about insider trading by providing incentives for people to come forward with information. However, some would argue that this may deter people from within an organisation from reporting or preventing insider trading before it occurs in the hope of receiving a bounty.

Questions for Submission

55. Should bounties be payable by the Securities Commission? If so, what limits should there be on payment?

Whistleblowers

295. The Protected Disclosures Act 2000 protects employees who disclose "serious wrongdoing" in accordance with the provisions of the Act. The Act provides for

disclosure within organisations and for referral of protected disclosures to appropriate authorities for investigation. A person who makes a protected disclosure or refers one to an authority is immune from civil, criminal or disciplinary proceedings in accordance with the Act by reason of having made that disclosure or referral.

296. Currently, insider trading is not specifically included in the definition of "serious wrongdoing" in the Protected Disclosures Act 2000. The definition is inclusive, so may include insider trading of a serious nature. However, there is doubt whether or not a person who disclosed information about insider trading will have the protection of that Act.

297. It is less likely that market manipulation would amount to serious wrongdoing within the meaning of the Act, given there is no clear statutory definition of such conduct. The only type of market manipulation that would clearly be serious wrongdoing under the Act would be an act, omission, or course of conduct that constitutes an offence of conspiracy to defraud under section 257 of the Crimes Act 1961.

298. If insider trading or market manipulation is made a criminal offence, then the Protected Disclosures Act would apply, as "*serious wrongdoing*" includes "*an act, omission, or course of conduct that constitutes an offence*". We should consider whether the Protected Disclosures Act 2000 should apply to insider trading or market manipulation, even if they are not made a criminal offence.

Questions for Submissions

56. Should the definition of "serious wrongdoing" in the Protected Disclosures Act 2000 be extended to cover insider trading and market manipulation?