THE SECURITIES AMENDMENT ACT 1988

INSIDER TRADING

DISCLOSURE OF INTERESTS IN LISTED SECURITIES

A SUMMARY

RUDD WATTS & STONE
SOLICITORS
AUCKLAND AND WELLINGTON

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THE SECURITIES AMENDMENT ACT 1988

Part (I) : Insider Traders

The Securities Amendment Act 1988 ("the Act") introduced insider trading laws into New Zealand effective as of 21 December 1988. The main objective of the insider trading legislation is to encourage early public disclosure of price-sensitive information on companies.

The Act contains four separate provisions outlawing different forms of insider trading conduct. Insider trading is not, however, made a criminal offence. Instead, civil remedies are provided to enable companies and persons dealing with insiders to take action in the Courts to obtain redress in the form of damages and a pecuniary penalty. In addition, the Courts are given powers to disqualify a person found to have carried out insider trading from taking part in the management of companies, or, where the person is a licensed sharebroker, to revoke that licence.

Criminal procedures would require an enforcement agency to be established and funded by government. Civil remedies, in contrast, do not cost the government money.

The heart of the insider trading provisions is contained in Sections 7 to 14 of the Act which set out four separate types of unlawful insider trading conduct. These are as follows:

(a) dealing with securities of a company by an insider of that company who has inside information regarding the company;

(b) tipping about the securities of a company by an insider of that company who has inside information regarding the company;

(c) dealing, (including a company) by an insider who has inside information regarding another company, in the securities of that other company;

(d) tipping, by an insider (including a company) who has inside information regarding another company, about the securities of that other company.

"Inside information" is defined in the Act as information which is not publicly available, and which would or would be likely to affect materially the price of the securities if it was publicly available. In order for the trading to be unlawful, the inside information must be held by the insider by reason of his position as an insider.

The definition of insider is also fairly wide. It covers the company itself, a director, a company secretary, an employee, a substantial security holder (having an interest in at least 5 per cent of the voting securities of the company), in addition to persons to whom information is passed in confidence by those insiders, and confidants of those persons. If an insider passes the inside information to a non-insider this is very likely to constitute the offence of tipping by that insider.

Exceptions:

(a) the "chinese wall" situation where certain persons in a company have inside information, but these persons do not take part in the decision to deal in the securities.

(b) insiders of a company may trade in the securities of that company even though they hold inside information, provided approved procedures are observed.

(c) purchases pursuant to the Companies Amendment Act 1963 are excepted.

It can be seen that in order to fall within the exceptions provided by paragraphs (a) and (b) above it is necessary to establish and maintain compliance programmes. Such programmes will constitute a defence under section 8 of the Act (in relation to the liability created by section 7 - ie dealing in securities by an insider who is a director, employee or secretary of an insider) only if the programme receives the approval of the Securities Commission and notice of the receipt of such approval published in the Gazette. Under sections 10, 12 and 14 of the Act it will be a sufficient defence to show that such programmes were in place and that they had in fact resulted in the individual responsible for an investment decision having no knowledge of inside information - under these sections it is not necessary to obtain the Commission's approval.

As this legislation has been in force since 21 December 1988 it is essential that all stock brokers, merchant banks, registered banks, public companies and accounting and law firms establish compliance programmes immediately. The exact kind of programme required by each of these businesses will vary and must be tailored to suit the individual circumstances of the business concerned. However, the bare bones of such a structure may include the following general precautions:

- The firm must have <u>written</u> policies on insider trading. In some cases employees should be required to sign a statement to the effect that they have read and understand the firm's policy on insider trading.

- A compliance department should be established to enforce the policy within the firm.

- Access to inside information should be restricted to those persons within the firm who "need to know" the information to perform their job. This may include restricting access to computer records, restricting access to files and to copies of documents, using code names for special projects and extending confidentiality requirements to outside advisors where they are called in.

- It may be appropriate in some cases to dissuade or prohibit absolutely employee trading in securities.

- In addition, the following specific measures have been developed in overseas jurisdictions. They have been accepted by American Courts and appear to be contemplated by the United Kingdom, Australian and New Zealand legislation as valid defences:

  (a) Chinese Walls
  (b) Restricted lists
  (c) Watch lists

(a) Chinese Walls - a Chinese Wall is a set of written policies and procedures designed to prevent the dissemination of non-public information acquired by one department of a firm to other departments within the firm. It should prevent the flow of information legimately held by one group of employees to other groups which may deliberately or inadvertantly misuse such information.

These devices have been considered extensively in the case law in the United States where the evolution of Chinese Walls has parallelled the evolution of large multi-service diversified financial institutions with their inevitable internal conflicts of interest.

On a practical level, when implementing a Chinese Wall, consideration should be given to the following measures:

- Physical or geographic separation of divisions within the firm.
- Separate supervision of divisions
- Separate access to files and computer records within divisions
- Restrictions on the transfer of the employees between divisions within the firm
- Channelling of communications between separate divisions of the firm through a compliance unit.

Probably the most important factor in establishing a Chinese Wall is to determine how high up in the organisation the Chinese Wall should be implemented. As previously noted, decisions such as this will vary considerably according to the different kinds of business operated by such firms.

(b) The Restricted List - a Restricted List is a list of securities which the firm is prohibited from recommending or trading either on its own account or on behalf of customers except for unsolicited trading. Its principal disadvantage is that when a stock is placed on the restricted list it will be necessary to circulate this fact widely. This in itself may serve as a signal to the market that a firm has significant non-public information which may of itself excite speculation in the market.

(c) Watch Lists - the Watch List is a list of securities with respect to which the firm possesses inside information. Unlike the restricted list the fact that the stock has been placed on the Watch List will not usually be widely known and the "tipping off" aspect which may occur with the placing of a stock on a restricted list is much less likely to occur when the stock is placed on a Watch List. In addition some firms place dummy securities on the Watch List so that even if the list is leaked it is unlikely to be useful to outsiders.

Having now considered the exceptions to the regime and the compliance programmes which should be established by all operators in the securities markets we now turn to consider the persons to whom an insider trader may be liable.

The insider trader is liable in damages to the company in relation to which he is an insider. The rationale for this liability is that the insider is in a fiduciary position in relation to the company regarding the use of that information and as such he should not use it for his own personal benefit. The quantum of damages is set as the amount of the gain or loss made by the insider, calculated by comparing the value of the securities at the time of the dealing by the insider with the value the securities would have had if the inside information used by the insider had been publicly known. In each case, the value the securities would have had will need to be assessed and proven by expert evidence.

The Court may also impose an additional liability upon the insider to the company in the form of a pecuniary penalty - as a discentive to insider trading. This penalty may be set at any amount up to three times the amount of the gain made or loss avoided, or the consideration paid for the securities.

The insider trader also has a liability to the person or persons with whom he traded. Where dealings are through the stock exchange, the other party to the transaction will almost certainly not be identifiable and so this liability will be only of academic importance. However, where the other contracting party can be identified, that person will have priority in recovering from the insider the amount of any loss suffered.

There is provision for shareholders of a company who suspect that that company may have a claim against an insider to seek an opinion from a Queen's Counsel on this point, at the expense of the company concerned. Further, the right of action of a company against an insider may be exercised by a shareholder on behalf of the company with the leave of court, and at the expense of the company.

We append as Appendix A a flow-chart outlining the operation of the Act in relation to insider trading.

Part (II) : Disclosure of Substantial Shareholders

The Act introduces disclosure requirements for substantial shareholders effective as of 1 July 1989. Impetus for legislation to require greater disclosure of information by those holding interests of 5 per cent or more in the securities of listed companies again stems from events within the last year when it has often been unclear who holds what securities in particular companies, and what agreements or options exist in relation to those securities.

The basic disclosure obligations in the Act (contained in Sections 20, 21 and 22) are straightforward. There are five situations in which an obligation to file a statutory notice arises, as follows:

(a) every substantial security holder in a listed company, as at 1 July 1989, must file a notice in prescribed form with that listed company, and with any stock exchange on which the securities are listed;

(b) every person subsequently becoming a substantial security holder in a listed company must file a notice in prescribed form with that company and with the stock exchange;

(c) where there is a change in the total number of voting securities held by a substantial security holder in a listed company, and the change is equal to 1 per cent or more of the total voting securities of the listed company, the substantial security holder must file a notice in prescribed form with that company and with the stock exchange;

(d) where a person ceases to be a substantial security holder, that person must file a notice in prescribed form with the relevant company and with the stock exchange;

(e) where the nature of the relevant interest held by the substantial security holder in the listed company changes, the substantial security holder must file a notice in prescribed form with that company and with the stock exchange.

The information which will have to be supplied in the statutory notices to be filed by substantial security holders has not yet been specified. As soon as this information and the forms of the required notices are available it will be important for public listed companies to put procedures in place aimed at ensuring compliance with the provisions of the Act. Directors should ensure that officers of such companies are aware of the Company's obligations under the Act and that compliance procedures are put in place.

A substantial security holder is a person who holds "a relevant interest" in 5 per cent or more of the voting securities of a listed company. What constitutes a relevant interest is defined very widely in Section 5 of the Act. It covers both any beneficial interest in a security, and any power to exercise the right to vote attached to a security. It also covers any option or other agreement under which a person has or may have a power to control the exercise of any right to vote, or a power to control the acquisition or disposition of the voting security.

The definition is made wider still by the provision that where one company holds a relevant interest, all related companies (i.e. holding companies or subsidiaries) also hold a relevant interest and, further, that a 20 per cent shareholder in a company which holds a relevant interest is also deemed to hold a relevant interest.

The Act contains an important compliance procedure (in Section 28) under which a listed company may serve a notice on the registered holder of voting securities requiring that person to disclose immediately and in writing details of every person holding a relevant interest in the securities which are registered in the name of that holder, and once that notice has been served an application may be made immediately to the Court for one or more orders relating to those securities. The object of this provision is to enable the Court to be involved very quickly where a listed company has grounds to suspect that undisclosed and significant dealings are going on in its shares.

The orders which the Court may make in the event of non-compliance with any of the obligations contained in Sections 20, 21, 22, and 28 are very wide. They include prohibiting the exercise of voting rights on securities, directing non-payment of dividends, prohibiting the transfer of securities, or ordering the forfeiture of securities. What orders are appropriate in any given situation is left entirely to the discretion of the Court. Non-compliance with the disclosure obligations contained in Sections 21, 22 and 23 also gives rise to a liability in damages which could potentially be extremely large (in Section 34).

Finally, it should be noted that companies which receive notices from substantial security holders are required to publicise them by keeping them in a file which is open to the public, and by publishing the identity of substantial security holders in a note accompanying the balance sheet put before the company at its annual general meeting.

<u>Part (III) : Futures Dealers</u>

Part III of the Act (effective as of 1 July 1989) covers the regulation of dealing in futures contracts. Essentially it provides that no person may carry on a business of dealing in futures contracts unless:

(a) that person is a member of an authorised futures exchange; or

(b) that person is specifically authorised by the Securities Commission to carry on the business of dealing in futures contracts.

The penalties for non-compliance with these provisions are large - individuals may face a fine of $100,000 or 3 years imprisonment, or both, and companies may face fines of up to $300,000.

Part IV: Miscellaneous Amendments

Part IV contains various amendments and additions to the Securities Act 1978. While some of these changes are of limited significance, others are of major importance. In particular, Sections 42 to 44 of the Act establish a new regulatory regime covering the issue of life insurance policies by life insurance companies. The broad exemption from the Act which previously applied to this kind of business is to be removed with effect from 1 July 1989 and from that date an authorisation from the Securities Commission will be required for life insurance companies to issue policies. These provisions were added to the Bill only shortly before it was enacted. Consequently, interested parties have had no opportunity to make submissions on them. In view of the importance of these provisions, this lack of opportunity for public discussion is unfortunate.

Summary

In conclusion it is worth emphasising again the dates on which the new legislative provisions become effective:

(a) The rules prohibiting insider trading are already in force - as from 21 December 1988. Immediate action may need to be taken by merchant banks, stockbrokers and other organisations which acquire inside information in the course of business to ensure that their practices and procedures comply with the law.

(b) A number of other important statutory provisions do not come into force until 1 July 1989:

- requiring the disclosure of substantial shareholdings
- regulating futures contracts
- regulating the issue of life insurance policies
- requiring increased disclosure of shareholdings by directors.

By that date, those affected by these provisions must ensure that they are familiar with the legislation and are in a position to comply with their obligations under the law. In the case of futures traders and life insurance companies this will involve having to take steps to obtain the authorisations which they need to do business.

PART I – INSIDER TRADING

Is a person an "Insider"?
– see section 3

No

Outside scope of Act

yes

Does that Insider possess
"Insider Information"
– see section 2 about a
"Public Issuer"?

No

yes

Section 7
Dealing in the Securities
of the Public Issuer of which
the person is an "Insider"

Section 9
Tipping by an Insider
who has Inside Information
i.e. passing information
about the Public Issuer of
which he or she is an Insider
to third parties.

Section 11
Dealing in the securities
of a Public Issuer other
than that of which the
person is an "Insider".

Section 13
Tipping by an
Insider who has
Inside Information
about a Public Issuer other
than that of which he is
an Insider.

Additional remedies available
to shareholders of Public Issuers
as well as persons to whom
the Insider is prima facie liable

Prima facie liable to the
persons set out in sections
7, 9, 11 and 13

May come within the exceptions
set out in Sections 8, 10, 12
and 14 – 3 classes –

- Purchase under Companies Amendment Act 1963
- Approved compliance procedure used
- Arrangements in place to ensure buyer/seller had no access to Inside Information <u>AND</u> they in fact did not have access to such information

<u>Sanctions</u> – Maximum amount of penalties
to be determined by reference to
sections 7, 9, 11, 13 and 16 of the Act.

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