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11 May 1993 CBL/3/5

Chief Executive
Securities Commission
P.O. Box 1179
**WELLINGTON**

Dear Mr Farrell

**PROPOSED PRACTICE NOTE ON INSIDER TRADING**

**Introduction**

1. This submission is in response to the Securities Commission's invitation of 28 September 1992 for views in relation to its proposed practice note on insider trading. It has been prepared by a subcommittee of the Society's Commercial and Business Law Committee ("the Committee") which has included several co-opted members. Where the Committee has not been unanimous the majority and minority views have been recorded. In respect of paragraphs 3.24 and 3.25 of the discussion paper the Society has a copy of Mr Ratner's letter to you of 7 May and advises that his was not the only minority view in respect of those paragraphs.

**General Comments**

2. The Committee supports the Commission's proposal to develop a practice note on its policies and procedures in relation to its discretions under the Securities Amendment Act. While it is acknowledged that such a practice note will not have any legislative basis, it is thought helpful to set out the criteria on which the Commission is to make its decisions so that the Commission's practices can be understood and commented on.

3. The Committee is of the view however that in some instances the propose practice note assumes discretions on the part of the Commission whic may not be conferred by the Securities Act or the Securities Amendmen Act. The Commission's proposals are an attempt to remedy absurdities i the legislation, which unfortunately may be either beyond it discretionary power, unauthorised by the Act, or simply insufficient t rectify the identified defect.

4. The Committee strongly recommends that the Commission promote a revie of the Securities Amendment Act to resolve these deficiencies and th many others in the legislation. The Committee sets out its view of th empowering provisions immediately below.

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Role of the Commission

5. Section 17 of the Securities Amendment Act requires that the approval of the Commission be obtained before a notice seeking a lawyer's opinion may be given. Section 17 also requires the Commission's approval of the lawyer to be instructed. In the Committee's view the Commission's role under section 17 is limited to deciding whether or not to give those two approvals. Having given those approvals, the Commission's role ceases and the matter is dealt with by the lawyer in accordance with the legislation. While the Commission may have the power to investigate particular instances of insider trading as a result of the decision in City Realties Ltd v Securities Commission [1982] 1 NZLR 74, that is a separate matter and one on which there are differing views within the Committee. Doubt as to the authority of the City Realties case in relation to matters under the Securities Amendment Act has been raised because of the recent decision in Telecom Corporation of New Zealand Limited v Commerce Commission and the fact that the Securities Amendment Act contains its own code for enforcement.

Discretions of the Commission

6. The Commission has two discretions. The first, as to whether to approve the giving of a notice, is not in the Committee's view unfettered. A Court would require the Commission to exercise its discretion so as to promote the purpose of the Act and to give effect to the provisions relating to the giving of approvals. The Committee thinks that the rationale is to limit the exposure of public issuers to the cost of seeking opinions in response to frivolous, vexatious or patently unsubstantiated suspicions. Accordingly the Commission's role in respect of its first discretion is to ensure that there is a reasonable possibility that a cause of action exists.

7. The second discretion of the Commission relates to the approval of the lawyer to be appointed. The Committee thinks the rationale of this discretion is to ensure that the lawyer is independent, has appropriate commercial experience to appreciate the significance of the factual material he or she is to receive and should ask for, and has sufficient legal skills and standing to provide an independent and authoritative opinion.

Commission's Functions

8. Section 10(1)(c) of the Securities Act states that one of the Commission's functions is to keep under review practices relating to securities, and to comment thereon to any appropriate body. The majority of the Committee takes the view that this does not authorise the Commission to collect information for the purpose of providing it to the appointed lawyer. One member of the Committee thinks otherwise. However, the Committee agrees that it would be appropriate for the Commission to provide any information that it has collected, for the purpose of making its decision, to the lawyer for his or her use.

9. Nor does the majority of the Committee think the general thrust of the Commission's proposal is appropriate. In effect it would shift the focus of the legislation away from what was intended to be an informal and inexpensive investigation and report by a skilled independent person, owing duties to the company, which would be balanced with the interests of the complainant in the course of preparing an opinion.

Instead it would result in a regulatory agency taking formal responsibility for an investigation and in reality for its outcome. In the majority's view it is wrong to try to separate the process of assembling and evaluating information from the forming of a legal opinion upon it. Indeed the Securities Amendment Act is so straightforward in many respects that the legal opinion flows almost automatically from the assembly of the relevant facts. The key legal judgments being exercised are as to what facts are relevant. The majority of the Committee would see little point in persisting with the involvement of the independent lawyer under the approach proposed by the Commission. On the other hand the majority does see value in the procedures pioneered by sections 17 and 18 of the Securities Amendment Act, which attempt to avoid some of the drawbacks of formal investigatory processes with the associated risk of cost escalating at an early stage beyond the importance of the issues involved.

10. Though the majority of the Committee does not elaborate on the suggestions in this letter it considers the Commission would be better advised to explore the amendments which might be made to section 17 to improve the process involving the approved lawyer.

Obtaining Evidence for the Commission's Purposes

11. The Commission has wide powers under section 18 of the Securities Act to summon witnesses, to take evidence and to require the production of material on any matter before it. In the Committee's view, the matters which might come before the Commission under section 17 of the Securities Amendment Act are whether or not to give its consent to a notice and whether or not to approve a lawyer. The majority think that it would therefore not be proper for the Commission to use its powers for the other purposes proposed, including the collecting of information for the lawyer's opinion. In the majority's view the Commission is authorised to collect information only to the extent necessary for it to establish "the reasonable possibility of a cause of action". It is then for the lawyer to assess whether such an action is available.

Confidentiality

12. As stated above, the majority of the Committee thinks that the Commission's only role in relation to an insider trading allegation is to exercise its discretions under section 17. The majority therefore thinks that section 19(5) of the Securities Act applies only to the proceedings of the Commission in relation to those matters. Any confidentiality order would have to cease at the termination of such proceedings and could not go beyond the time of the Commission's decision on whether to approve a notice under section 17 (Section 19(5)(b)). If it is desired that confidentiality orders continue after the determination of the proceedings, section 19(5)(b) would have to be amended and clarified. As noted in paragraph 19 below, the Committee would support the continuation of confidentiality orders beyond the conclusion of the Commission's proceedings.

## Specific Comments

13. The Committee's specific comments are set out on a paragraph by paragraph basis.

4. Paragraph 2.1.3: This paragraph implies that the lawyer has an investigative role and may obtain any necessary further information. The Committee thinks that the role of the lawyer can only be to give his or her opinion after considering the representations made by the complainant and the public issuer, any information provided to him and any other relevant matters (section 17(3)). The lawyer would ordinarily identify gaps in the information received and may, if he or she considers it appropriate, seek additional information in order to form a properly based opinion. However the majority of the Committee thinks the lawyer is not required to investigate further if the lawyer does not think it appropriate. If there is insufficient evidence available, there is then no cause of action available to the company.

15. Paragraph 2.1.4(a): The majority of the Committee thinks that the preparation of an opinion by the Commission as to a cause of action would be outside its function under section 10(1)(c) of the Securities Act to keep under review practices relating to securities.

16. Paragraph 2.9: See the Committee's view expressed in paragraph 12.

17. Paragraph 3.5: The Committee thinks that it would usually be desirable for the Commission to notify the insider and the public issuer that it has been asked to approve a notice pursuant to section 17, and to give them the opportunity to be heard. It need not, however, be an invariable practice.

18. As a general comment it seems that resolution of some of the issues of procedure might best be helped by taking account of the duties of the appointed lawyer to the company and its interests.

19. Paragraph 3.6: See the Committee's comments in paragraph 12. In the majority's view, it would be desirable for confidentiality to be applied to all applications to give notice under section 17, and to continue until the matter is taken to Court. However, section 19(5) is not currently helpful in this regard, beyond the completion of the Commission's deliberations.

20. Paragraphs 3.7 to 3.10: Collection of information for the preparation of the opinion would, in the majority of the Committee's view, be beyond the functions of the Commission.

21. Paragraph 3.7: If the Commission is unable to make a decision on whether to approve a notice without the evidence of the public issuer, the Committee thinks the Commission should request that evidence and if necessary require it.

22. Paragraph 3.9: Because the Securities Amendment Act does not impose a criminal sanction, the Committee agrees that the privilege against self incrimination would not protect insiders against the requirement to disclose evidence to the Commission where that evidence would establish liability under the Act.

23. Paragraph 3.11: The Committee thinks that a deferral or refusal of an approval by the Commission for a purpose alien or contrary to the rationale for the discretions in section 17 would be unlawful. It may be appropriate however for the Commission to defer a decision while investigating whether there is a reasonable possibility of a cause of action. It may also be appropriate for the Commission to refuse or

defer its approval where the particular matter on which an opinion is sought is already before the Court.

24. Paragraphs 3.13 to 3.15 and 3.19: Section 17(1) of the Securities Amendment Act allows a notice to be given only in respect of insiders against whom the person giving the notice considers that the public issuer has, or may have, a cause of action. The Committee does not think that a notice can refer to persons who are not insiders or those against whom the applicant does not consider the public issuer may have a cause of action. The Committee also thinks that for a notice to refer to members of a named class (including a class, for example, of directors), the applicant must consider that the public issuer has, or may have, a cause of the action against each member of that class. Accordingly, in the Committee's view, section 17(1) does not allow a notice to be given in respect of "any other person".

25. The Committee considers that the legislation is unnecessarily restrictive in this area. In the ordinary course a lawyer for an issuer would draw to the issuer's attention possible rights against other persons which came to attention when reviewing material.

26. Paragraphs 3.18 and 3.19: For the reasons set out above the Committee does not favour the approach set out in these paragraphs.

27. Paragraph 3.22.2(i): The Committee notes that compliance with the procedure approved by the Commission might not necessarily result in the application of the exemption under section 8(1). There are three limbs which need to be satisfied before the exception in section 8(1) applies. As compliance with either procedure under the Insider Trading (Approved Procedure for Company Officers) Notice 1993 would not necessarily "ensure" that the insider does not use inside information in selling or buying securities of the public issuer for personal gain, this would not avail an insider of the statutory exception to liability. This is one respect in which the Act ought to be amended.

## The Examples

28. Paragraph 3.24: The majority of the Committee thinks that transactions between parties with equal knowledge should not be subject to the Act. However, there is no statutory exception where both vendor and purchaser have the same inside information. The minority thinks that the transactions between informed persons should not be permitted as that would remove the incentive for those persons to disclose their inside information prior to trading, which would be of benefit to the other participants in the market.

29. It is likely in such circumstances that the price agreed by the vendor and purchaser would be the value of the securities, as determined in accordance with section 15(2) of the Securities Amendment Act. Substantial liability is therefore only likely to arise, if at all, as a pecuniary penalty. However, the matters identified in section 16 would assist the Court in ensuring that any pecuniary penalty is not significant. The only remaining penalty for individuals would be the effect on their ability to act as a director or manager of a company.

30. As the penalties are likely to be insignificant, the Commission could justify declining to exercise its power to approve a notice under section 17 on the basis that the breach is of a technical nature only

with no substantial penalty, and therefore not worthwhile pursuing. This is considered by the majority of the Committee to be a desirable result in these circumstances. However, where substantial liability is a possibility, the Committee's view is that the Commission would not be able to avoid approving the notice, as a clear and substantial cause of action could arise. In the Committee's view, the Commission cannot withhold its approval where, because of the wide ambit of the Act, the consequences if liability exists would be harsh and inappropriate.

31. The majority of the Committee recommends that the Act be amended to permit transactions where both vendor and purchaser have the same inside information. In the majority's view it would be little comfort to market participants who wished to trade with other parties with equal knowledge to know that the Commission was unlikely to approve a notice under section 17, particularly when the exercise of the Commission's discretion would not prevent an action under section 18. Moreover, from an adviser's point of view it would be unsatisfactory having to explain that the law was not consistent with normal commercial expectations of ethical conduct.

32. Giving the Commission a discretion to relieve harsh results when breaches occur is unfair to the majority of persons who comply with the letter of the law. The Committee does not favour legislation which uses discretions exercised after a breach to remedy imperfections in the legislation. It prefers certainty; unnecessary restrictions should be addressed by amending the legislation.

33. Paragraph 3.25: The Committee recognises that many transactions taken in good faith might in hindsight be shown to involve insider trading, especially where the use of the information has been in the interests of the public issuer concerned (such as full disclosure to potential underwriters). The majority of the Committee recommends that the Act be amended to allow a defence, similar to those in section 59(2) or section 63 of the Securities Act or section 468 of the Companies Act 1955, for those who can satisfy the Court that having regard to all the circumstances of a case they ought reasonably to be excused. The minority thinks that allowing a defence in these circumstances would remove the incentive for persons to disclose their inside information, prior to trading, for the benefit of the participants in the market.

34. Party A could have encouraged her company to adopt the procedures approved by the Commission under section 8(1)(c). Subject to the defects noted in paragraph 27 above, compliance with that procedure may have provided a defence.

35. In answer to the question posed, the Committee thinks that the Commission should be able to decline to act. However, as a matter of law, it is unable to do so for the same reasons as described earlier. Even if the Commission could decline, this would not prevent an action being brought under section 18; accordingly the Commission's discretion would not provide adequate protection to Party A.

36. Paragraph 3.26: The Committee thinks that information held by C in his capacity as a director of B would not be ascribed to C unless it were understood, or a condition of A's appointment, that he had received his information as a director of B for or on behalf of, or in his capacity as, a director of C. Accordingly, as the Commission is satisfied that

no information is passed to C, there is no reasonable possibility of a cause of action, and approval could therefore be declined.

37. Paragraph 3.27: The Committee agrees that the Commission should not exercise its discretion in favour of obtaining an opinion where trivial, vexatious or technical breaches occur. However, the Committee doubts that the Commission can avoid giving its approval where a breach occurs in the other "ethical trading" categories mentioned. As a matter of policy, the Committee thinks that the ambit of the Securities Amendment Act should not apply to the "ethical trading" category referred to in paragraph 3.27 and that the Act should be amended accordingly.

38. Paragraph 3.28: As stated earlier (paragraph 11), the majority of the Committee thinks that assembling information for the lawyer for the purpose of forming an opinion does not come within the ambit of section 18 of the Securities Act. The powers under section 18 are for gathering information on matters before the Commission. In this instance the matter before the Commission is whether it should give its approval to the seeking of an opinion from a barrister or solicitor and who that solicitor or barrister should be. The Commission is empowered to receive such evidence as it needs to make those decisions, but it may not seek information which might subsequently be useful to the lawyer for the purposes of forming an opinion.

39. Paragraph 3.30: See the Committee's comments in respect of paragraph 3.28.

40. Paragraph 3.31: See the Committee's comments in paragraph 48.

41. Paragraphs 3.33 to 3.34: In the Committee's view, the Commission has no power to intervene or to lay down procedures after the lawyer has been appointed.

42. Paragraph 3.35: The Committee agrees with the answer given by the Commission. However, in the Committee's view there should be one reservation. Section 17 acts as a safeguard for members of the company where the conflicting interests of the directors may prejudice a proper pursuit of remedies under Part I of the Act. For this reason the lawyer should not regard himself or herself as subject to the instruction of the company's board. The duty of the lawyer must be to act in the best interests of the company as they are perceived by the lawyer. Views expressed or instructions given by directors (particularly those who have been accused) should not bind the lawyer.

43. Paragraph 3.36: The Committee thinks that the views of the alleged insiders are an "other relevant matter" (section 17(3)) which the barrister or solicitor is required to consider. This will depend on the circumstances, however, and where no cause of action is found there may be no need to seek submissions from them. However, in all cases where a cause of action is found, except the most exceptional, the Committee thinks those against whom the allegations have been made have a right to be heard.

44. Paragraph 3.37: In the Committee's view there is no requirement to provide the complainant shareholders with the information described in paragraphs (a) to (d). The Committee agrees that the lawyer has an explicit obligation to consider the representations of the complainant shareholders. This does not grant the complainant shareholders a right

to see a discussion paper, but the lawyer may distribute one if he or she so wishes.

45. Paragraph 3.38: There are circumstances where the lawyer may be compelled to seek independent advice so that he or she can complete the opinion. This would be authorised by section 17(3)(c). See the Committee's opinion on confidentiality orders in paragraph 48 below.

46. Paragraph 3.39: In the Committee's view the barrister or solicitor may seek assistance or advice, provided that the opinion formed on the question of whether there is a cause of action is that of the barrister or solicitor. The lawyer is not prevented from adopting expert advice in the opinion if he or she agrees with it. (See paragraph 8 above in relation to the Commission acquiring information for the purpose of the barrister or solicitor's opinion, rather than for its own purposes.)

47. Paragraph 3.40: In the Committee's view the lawyer has no discretion as to the identity of the persons in respect of whom enquiries may be made. If there are reasons why an opinion should be sought in respect of other persons, a further notice would be required. Incidentally the notice is given by the complainant rather than the Commission.

## Publicity

48. The majority of the Committee thinks that the opinion should be kept confidential until the matter comes before the Court which may then decide if a confidentiality order should be granted. Allegations of insider trading are a serious matter and those against whom allegations have been made should not be tried by the media before a matter comes to court. A minority of the Committee believes that it is not sensible to try to muzzle complainants, and not in the interests of the market to be seen to try. On this view, confidentiality should only attach to material provided to the Commission by those who wish to have it remain confidential, and the Commission should educate the market (and the financial press) to the reality that the fact of referral under section 17 could be quite routine and should be regarded as such until a report is provided; and that the Commission grants its approval freely and no significance should be read into such a grant.

## Review of Legislation

49. The Committee urges the Commission to review the provisions of Part I as soon as possible. There are significant anomalies under the Act which could be resolved by amendment.

50. Paragraph 5.1: The Committee thinks that it could be desirable for the Commission to be able to assist with the collection of information for the lawyer to prepare his or her opinion. To preserve the cost efficiency and informality of the process intended by the legislation this should be a reserve power, exercised in respect of specific issues identified by the lawyer at his or her request. In effect the existence of the power should be a sanction sufficient that it is rarely invoked. It should not be routine.

51. Paragraph 5.2: It is unclear what sort of orders are envisaged. The Committee thinks the Commission should be able to bring an action on behalf of a public issuer under section 18(1) with the approval of the Court.

52. Paragraphs 5.1.3 and 5.1.4: The Committee thinks the Court should have the power to make such orders.

## Conclusion

53. The Committee has asked me to apologise to the Commission for the delay in responding to the Commission's invitation to comment. The Committee has asked that it be noted, however, that earlier submissions made by the Society in respect of a proposed procedure under section 8(1)(c) of the Securities Amendment Act (my letter of 1 May 1991) also pointed to the need for legislative reform and the undesirability of attempting indirectly to mitigate unintended consequences of the legislation. The Committee members believe that experience in their practices has demonstrated the unfortunate effect of these partial remedies and that the Commission should not proceed to issue practice notes which fail to acknowledge such difficulties.

54. The members of the Committee would be happy to discuss any aspect of the submission with the Commission if it would be of any assistance.

Yours sincerely

Alan Ritchie
**Executive Director**