

REVIEW OF THE LAW ON INSIDER TRADING

A DISCUSSION PAPER

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Introduction

The rules of law relating to insider trading are contained in Part I of the Securities Amendment Act 1988 ("the Amendment Act") and elsewhere. These came into force in December 1988 and have thus been in force for in excess of 5½ years. The Commission considers it timely to review these rules of law.

In the course of this review, we have formulated a number of suggestions for reform on which we would welcome comment from interested persons.

1. **Extension of the definition of "insider" to include employees of related parties of public issuers.**
 - 1.1 The Commission has received a number of representations that the definition of "insider" should encompass company officers of related companies of the public issuer, with respect to information "about the public issuer" that those company officers have or receive in the course of their employment.
 - 1.2 This would have two principal effects. First, it would expose officers of related companies of public issuers to liability in respect of inside information about the public issuer. This would be so notwithstanding that the information may have been information of the related company. Secondly, it would provide a proper basis on which to extend the protections of the Insider Trading (Approved Procedure for Company Officers) Notice 1993 to company officers of related companies of public issuers. At present this notice may only be used by directors and employees of a company that is a party to a listing agreement, and not by directors and employees of related companies of that company.
 - 1.3 The suggestion could be implemented by amending section 3(1) of the Amendment Act by inserting the following underlined words:

"For the purposes of Part I of this Act, "insider", in relation to a public issuer, means -

- (a) *the public issuer;*
- (b) *a person who, by reason of being a principal officer, or an employee, or a company secretary of, or substantial security holder in, the public issuer, or a related company of the public issuer, has inside information about the public issuer or another public issuer;"*

1.4 The term "related company" would be defined as having the same meaning as in Part I of the Companies Act 1993.

1.5 Section 3(2) of the Amendment Act would be similarly amended to provide that inside information possessed by a company officer of a related company is presumed to be held by that company officer by reason of that person being a company officer of the related company.

1.6 Section 8(1) of the Amendment Act would be amended to allow company officers of related companies of the public issuer to take advantage of the approved procedure for company officers. We suggest, for consideration, that section 8(1) could be amended to read that:

"No action shall be brought under section 7 of this Act against a director, or company secretary, or employee of a public issuer or a related company of the public issuer if - "

1.7 The Insider Trading (Approved Procedure for Company Officers) Exemption Notice 1993 would then be consequentially amended.

2. Giving the Commission the power to require a lawyer appointed pursuant to section 17 of the Amendment Act to consult with the Commission on the preparation of the opinion.

2.1 The role of the Commission with regard to a lawyer appointed under section 17 should, in our opinion, be amplified. We think the section should sanction the presently evolving practice that the lawyer will routinely consult the Commission.

2.2 We think it is appropriate for this purpose that the Commission have power to request the lawyer to consult with the Commission, the purpose being to empower the Commission

to assist the lawyer in ensuring that the opinion is prepared in a timely, efficient and cost-effective manner.

- 2.3 We suggest for consideration the following amendment to section 17 to allow for such consultation:

17(3A) The barrister or solicitor shall -

- (a) consult with the Commission, to the extent required by the Commission, as to the preparation of the opinion:*
- (b) provide such reports as the Commission may require on the preparation of the opinion.*

(This wording is largely uplifted from section 121(2) of the Reserve Bank of New Zealand Act 1989).

3. Giving the Court power to direct any person to reimburse the costs of the public issuer in obtaining an opinion pursuant to a notice under section 17

- 3.1 The provision of a section 17 opinion is at the public issuer's expense. Certain public issuers have expressed the opinion to us that it may sometimes be inappropriate for the public issuer to continue to bear the full costs of obtaining the opinion, particularly where the issuer has obtained a judgment against an insider under Part I. Accordingly, we suggest for consideration the following amendment to section 17, which is intended to allow a public issuer to recover costs from any person that the Court considered appropriate:

17(6) The Court may, on application by the public issuer, make an order directing any person to reimburse any part of the costs of the public issuer in obtaining an opinion from a barrister or solicitor pursuant to section 17 of this Act.

- 3.2 We had considered whether to exclude from this clause a shareholder who had requested a section 17 opinion. On balance, we do not think it jurisprudentially sound to limit the discretion of the Court to make an order against any shareholder or any class of shareholders.

4. Giving privilege to publication of the opinion of the lawyer.

- 4.1 The media have had difficulty in deciding how to handle a section 17 opinion. At present it does not attract any form of privilege from proceedings for defamation notwithstanding that copies are available to shareholders, present and past.
- 4.2 The Commission believes that it may be appropriate to confer qualified privilege from proceedings for defamation upon section 17 opinions. This could be effected by providing that section 17 opinions be specified in Part II of the First Schedule to the Defamation Act 1992.
- 4.3 This would have the effect of affording a defence to proceedings for defamation if:
- (a) publication is not prohibited by a lawful order;
 - (b) the opinion is a matter of public interest; and
 - (c) if the media carries a report on the opinion, the media must accede to a request by a defamed party to print a reasonable letter or statement by way of explanation or contradiction.
- 4.4 A related issue is the provision of a preliminary statement or a draft of parts of the lawyer's opinion to a limited group of persons (such as named insiders). This may expose the lawyer to a claim in defamation. While we think it unlikely that an insider would choose to bring proceedings for defamation, and less likely still that the Court would find that a cause of action exists, we think that, in the interests of certainty, this matter should be clarified. Accordingly, we suggest that the Amendment Act provide that all communications between the lawyer and any other party for the purposes of forming an opinion on whether a public issuer has a cause of action against an insider should be privileged from proceedings for defamation.

5. Giving a copy of the lawyer's opinion to any person against whom the public issuer may have a cause of action.

On occasions the lawyer is asked to consider whether or not a public issuer has cause of action against a person who is not and has not been a member of the public issuer. The person may have been an insider who advised or encouraged others to buy or sell securities. It seems important that the public issuer should be obliged to give a copy of the lawyer's opinion to any such person as of right. We suggest for consideration that section 17(3) be amended to require this.

6. Giving the Commission standing to apply to the Court for orders in relation to insider trading

6.1 The Commission has observed the often understandable reluctance of public issuers to instigate proceedings for insider trading where the costs of bringing proceedings are borne by the public issuer itself. It seems likely that insider trading laws would be more effectively enforced if the Commission had standing to bring proceedings.

6.2 The Commission suggests for consideration the following additional provision in the Amendment Act:

18A(1) Where, at any time, the Commission is of the opinion that a public issuer has, or may have, a cause of action against an insider under this Part of the Act, the Commission may, in its discretion -

(a) bring proceedings against the insider in the name of and on behalf of the public issuer; or

(b) with the leave of the Court, intervene in proceedings brought under this Part of the Act to which the public issuer is a party for the purpose of continuing, defending, supporting or discontinuing proceedings on behalf of the public issuer.

18A(2) The Court shall give leave to an application of the Commission under this section, unless there is good reason for the Court not to do so.

(The wording of this section is largely drawn from section 163 of the Companies Act 1993, which relates to derivative actions by shareholders).

6.3 The exercise of a public issuer's right of action under the proposed section 18A(1)(a) is not conditional on the Commission first obtaining the leave of the Court. This is consistent with the policy of Part II of the Amendment Act (which relates to substantial security holders).

6.4 The circumstances in which the Commission might be expected to act under this power would include:

(a) where the public issuer is in receivership and unable to fund proceedings,

- (b) where the issues are complex and the resources of the Commission, have been required to assist the section 17 barrister to prepare his/her opinions.
- (c) there is no shareholder willing to fund an application under section 18 and the company is unwilling to commence proceedings under the liability sections of the Amendment Act.

6.5 The character of the proceedings would otherwise remain unchanged. They would remain civil and any money recovered from an insider would be held on trust by the public issuer pursuant to section 19 of the Amendment Act.

7. Giving the Court the power to direct any person to reimburse any or all of the costs of the Commission in respect of any proceedings in the Court under the Amendment Act.

7.1 If the Commission is to have the power to bring proceedings, we suggest that it may be appropriate to confer on the Court the discretion to provide for quite full recovery of costs incurred by the Commission in respect of any proceedings brought under Part I, also Part II, of the Amendment Act.

7.2 We suggest for consideration the following draft section for inclusion in the Amendment Act:

6A(1) The Court may, on application by the Commission, make an order directing any person to reimburse the Commission in respect of all or any costs incurred by the Commission in respect of any proceeding before the Court under Part I or Part II of this Act.

6A(2) In determining the amount of any reimbursement of the Commission in relation to the proceeding, the Court shall consider -

- (a) *any solicitor/client costs of the Commission:*
- (b) *any disbursements of the Commission:*
- (c) *any other costs of the Commission.*

8. **Imposition of an objective test for the "Chinese Wall" exception to apply.**

8.1 The Commission has conducted a number of inquiries into insider trading where the "Chinese Wall" exception (sections 8(3), 10, 12(2) and 14 of the Amendment Act) has been asserted. The text of section 8(3) reads:

"No action shall be brought against an insider under section 7 of this Act, in relation to the sale or purchase of securities in a public issuer, if -

(a) Arrangements existed to ensure that no individual who took part in the decision to buy or sell the securities received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information; and

(b) No individual who took part in the decision to buy or sell the securities received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information."

8.2 In general the quality of the Chinese Walls described to us in evidence in various sharedealing enquiries undertaken by the Commission has not been good and on occasions, we are persuaded, was not in itself a satisfactory basis to exclude liability for insider trading.

8.3 We think it insufficient for the purpose of the Chinese Wall exception that "*arrangements existed to ensure*" that no individual who bought or sold had access to inside information without considering whether the arrangements were likely to be effective for this purpose. We suggest that the wording of para (a) of the test be amended to read "*Arrangements existed that could reasonably be expected to ensure ...*". The effect of this suggested amendment would be to require not only that Chinese Wall arrangements existed but also that they were sufficiently robust to persuade an objective observer that the confidentiality of inside information was likely to be protected.

8.4 In this regard, we note that this suggested amendment is compatible with the Australian legislation. The Australian Chinese Wall provision was changed, with effect from 1 January 1991, from words matching our current wording to "... arrangements that could reasonably be expected to ensure ..." (c.f. sections 1002N and 1002M Corporations Law 1991, section 128(7) Securities Industry Act 1980).

- 8.5 It is to be noted that section 8 (1)(b) of the Amendment Act which relates to the power of the Securities Commission to approve procedures for trading by company officers in the shares of their company employs similar wording to that used in section 8(3). Section 8(1)(b) reads:

"(b) *In selling or buying the securities that person complies with a procedure operated by the public issuer for ensuring that no director, company secretary or employee who has inside information about the securities of the public issuer uses that information in selling or buying securities of the public issuer for personal gain*" (emphasis added);

- 8.6 The Commission's present approved procedure under section 8(1) is the Insider Trading (Approved Procedure for Company Officers) Notice 1993. We do not suggest that an objective test should be prescribed in section 8(1). The procedure has been prescribed by the Commission by notice in the Gazette and it should be sufficient for the company officer to demonstrate compliance with the procedure. However some commentators have argued that the words "*for ensuring*" import on the part of the company officer an obligation to demonstrate that the company officer cannot by virtue of the procedure have used inside information in selling or buying securities. We do not think this is the intent of the law. To clarify what we believe to be the intent of the law we suggest that section 8(1)(b) be modified to read:

"... complies with a procedure operated by the public issuer for the purpose of ensuring ..."

9. The Commission's function to keep under review practices relating to securities.

The Commission has a function under section 10(c) Securities Act 1978 to keep under review practices relating to securities and to comment thereon to any appropriate body. From time to time counsel acting on behalf of parties to Commission enquiries have argued that Part I, also Part II, of the Amendment Act each constitute complete codes in respect of the matters to which they relate. Accordingly the Commission's power of comment under section 10(c) of the Securities Act does not apply to practices relating to insider trading or substantial security holding, at least insofar as they relate to the specific facts under enquiry. The Commission has several times had occasion to reject this argument.

It seems desirable in the interests of an informed market to clarify the role of the Commission in relation to market enquiries.

We suggest that a new provision be included in the Amendment Act, perhaps in section 2, that nothing in the Amendment Act is intended to limit the discretion of the Commission under section 10(c) Securities Act to review or comment on any matter in accordance with the general law.

Comments on the Suggestions for Reform

The Commission welcomes any comments on these suggestions, as well as any comments on possible further reforms. We request that comments be received by the Commission before 28 October 1993. Please address all submissions to:

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P.D. McKenzie
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