SECURITIES COMMISSION

27 June 1996

REVIEW OF THE LAW ON INSIDER TRADING

RECOMMENDATIONS

Our recommendations for reform are:

1 Extension of the definition of "insider" to include employees of related parties of public issuers.

1.1 We recommend that the definition of "insider" should be amended to include 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 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 We recommend section 3(1) of the Amendment Act be amended by inserting the words underlined below:

> *"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 of a related company of a public issuer, has inside information about the public issuer or another public issuer;"*

1.4 The term "related company" would be defined to have 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, as follows:

> "*No action shall be brought under section 7 of this Act against a director, or company secretary, or employee of a public issuer* <u>*or of a related company of a public issuer*</u> *if* - ".

1.7 The Commission would amend The Insider Trading (Approved Procedure for Company Officers) Notice 1993 consequentially.

1.8 All submissions received on both discussion papers were in favour of the recommendation.

2 To clarify the application of the Commission's Insider Trading Notice to the insider's spouse or child

2.1 Under the present law the benefit of any Commission insider trading notice may apply in respect of securities sold or purchased in the insider's "*own name or in the name, or on behalf, of that person's spouse or child*" (section 8(1)(a)). We have had difficulty in interpreting these words. We consider the section is intended to apply in respect of securities sold or purchased by the insider either in his/her own name or in the name of his/her spouse or child and either on his/her own behalf or on behalf of his/her spouse or child. We recommend that the section should say so more clearly.

2.2 All submissions received were in support of this proposal.

3 To give a lawyer appointed pursuant to section 17 of the Amendment Act authority to consult with the Commission while preparing the section 17 opinion.

3.1 We think the role of the Commission with regard to a lawyer appointed under section 17 should be amplified. We think the section should sanction the presently evolving practices:

(a) that the Commission obtains information for the lawyer, particularly information which is not readily available without the use of the Commission's statutory powers, and

(b) that the lawyer routinely consults the Commission.

3.2 The source of the lawyer's instructions is ultimately the Board of Directors of the public issuer. Questions have occasionally arisen about the impartiality of directors of a public issuer and suggestions made that the Commission's role should be more clearly stated.

3.3 Previously we had suggested for this purpose that the Commission should have power to require the lawyer to consult the Commission, the purpose being to empower the

Commission, at its discretion, to assist the lawyer in ensuring that the opinion is prepared efficiently. However, in the view of certain commentators, it is possible that a power of this type could limit the flexibility of the process and could be perceived as prejudicing the independence of the lawyer. After considering these comments we have decided to limit our recommendation to empowering the lawyer to receive information from the Commission and to consult the Commission.

3.4 Most respondents support this proposal.

3.5 We recommend the following amendment to section 17:

17(3A) The barrister or solicitor may -

(a) receive from the Commission the books or papers of any person which may be material to the preparation of the opinion,

(b) consult the Commission in the preparation of the opinion,

(c) provide such reports to the Commission as the barrister or solicitor thinks fit from time to time in the course of preparation of the opinion.

4 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 recommend that section 17(4) be amended to require this.

5 Not to confer privilege in respect of publication of the lawyer's opinion but to confer privilege in respect of communications between the lawyer and potential insider.

5.1 The media have informed us that they have had difficulty in deciding how to handle a section 17 opinion. At present it does not attract privilege from proceedings for defamation notwithstanding that copies are available to shareholders, present and past.

5.2 The Commission observes that the opinion of a barrister or solicitor under section 17 has not been tested by judicial process. It remains important that the opinion should not be accorded a quasi-judicial status. On balance we do not think it appropriate to confer qualified privilege from proceedings for defamation in respect of section 17 opinions.

5.3 A related issue is the provision of a preliminary statement or a draft of parts of the lawyer's opinion to other persons, for example, the provision of a draft statement about named insiders to other affected persons for comment. 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 recommend that the Amendment Act provide that all confidential 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 absolutely privileged from proceedings for defamation.

5.4 All respondents to the discussion papers agreed there should be no privilege in respect of the lawyer's final opinion . All respondents also agreed that communications between the lawyer and potential insider should be privileged.

6 **To empower the Court to approve settlement of insider trading claims.**

6.1 It is important that avenues should remain open for the settlement of insider trading claims other than by determination of the High Court. It is clear from experience to date that many insider trading claims may lend themselves to settlement in much the same way as other legal disputes. However special care must be taken in relation to claims to which the public issuer is a party arising under Part I of the Amendment Act.

6.2 Special features include:

(1) the claim may arise irrespective of any conventional loss by the public issuer;

(2) the public issuer may be obliged to obtain legal advice on the initiative of a security holder;

(3) the right of action of the public issuer may in certain circumstances be exercised by a security holder;

(4) a pecuniary penalty may be imposed at the discretion of the Court if the matter proceeds to trial;

(5) a security holder may be entitled to share in the distribution of any amount recovered by the public issuer from an insider.

6.3 We think it important to ensure that the potential benefit of these features to the company and its security holders should not be lost in the course of formulating procedures to facilitate the settlement of claims by processes other than proceedings in the High Court. We are not sure that the benefit of these features necessarily applies to the settlement process at present.

6.4 Part I does not address explicitly the situation which arises where there is reason to believe that the public issuer has not taken security holders' interests sufficiently into account in reaching a settlement or that the settlement is a sham. We think it should address this matter in order to meet the wider policies of the law. At the present time the remedy available to the shareholder appears to be to apply to the High Court under section 18 of the Amendment Act for leave to exercise the public issuer's right of action

against the insider, the court being required to give leave unless it is satisfied that:

(a) the public issuer does not have an arguable case against the insider; or

(b) there is good reason for not bringing the action.

6.5 This appears unsatisfactory to:

(a) the public issuer - which is not readily able to determine the possible courses of action available to shareholders in this type of situation;

(b) the security holders - whose rights are not readily identifiable where a settlement has already been entered into;

(c) the insider - the extent of whose exposure to litigation is not clear where a settlement has already been entered into.

6.6 There is need for more certainty about the position of each of these three groups and for better procedures for ascertaining whether the public issuer has taken all appropriate steps to pursue any material claims which are reasonably open to it, in the interests of the public issuer and of all those persons who may be entitled to act through it or to benefit from any distribution on the recovery of any funds.

6.7 For this purpose we recommend that the High Court should have power under section 18 to approve the settlement of any claim by a public issuer under Part I, whether or not the procedures under section 17 have been invoked. In addition, we recommend that the Court should have power to issue directions as to the distribution of any amount recovered or to be recovered under the terms of such a settlement. Arguably the Court already has this latter power under section 19 of the Amendment Act but this should be made clear. These powers of the High Court should be exercisable on the application of either party to the settlement, the issuer or the insider.

6.8 If the public issuer does not seek approval to a settlement and directions as to distribution it is our recommendation that the settlement is binding on the parties, subject however to any section 18 review as proposed above in para 6.7.

6.9 We also recommend that where:

(a) the public issuer and the insider negotiate a settlement, and

(b) the public issuer or the insider does not seek Court approval to the settlement,

the Court should not have power to award costs against the security holder in any action for review brought under section 18 as recommended in paras 6.7 and 6.8 above. A security holder should be able to test the Court's preparedness to direct the bringing of proceedings under section 18 without having to face the risk that, if unsuccessful, costs could be awarded against the security holder.

6.10 All the respondents who commented on this matter agreed with the policy of the recommendation.

7 Applicant for leave to exercise public issuer's right of action not to be liable for Court costs.

7.1 An application under section 18 of the Amendment Act for leave to exercise the public issuer's right of action may sometimes be a prolonged matter. A number of persons have said to us that while they may be willing to meet their own costs in making the application they apprehend a possibility that the Court may make an award of costs against them if the application is not successful. They are not willing to subject themselves to this risk.

7.2 We think this is a genuine concern. We also think it undesirable that the matter should not come before the Court solely on this ground. We think that security holders should not be exposed to the risk.

7.3 Consistent with our recommendation in para 6.9 above we recommend that section 18 be amended to exclude the power of the Court to award costs against a person who has applied for leave to exercise the issuer's right of action, this to apply only where the person is seeking to advance a cause of action identified in a section 17 opinion.

7.4 Many respondents considered that this raised more fundamental questions about civil enforcement generally. They referred to cost barriers, inequality of resources between the parties and difficulties associated with the enforcement of insider trading legislation generally. The respondents preferred solution was an enforcement agency. This matter is dealt with in section 10 below. It is not directly material to the recommendation we make above in para 7.3.

8 The Court to have power to direct any person to reimburse the costs of the public issuer in obtaining an opinion pursuant to a notice under section 17

8.1 The preparation 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 appropriate for the public issuer to recover from another interested party the costs of obtaining the opinion, particularly, but not necessarily, where the issuer has obtained a judgment against an insider under Part I. We agree.

8.2 Previously we had suggested that such a clause should not explicitly exempt the security holder who had required the section 17 opinion. However, we received very strong submissions on this from a number of interested persons. Commentators perceived that the absence of immunity was a strong disincentive to action under an amended section 17, notwithstanding that the Commission had sanctioned the preparation of the opinion. On reflection we agree. In particular, we note in reaching this conclusion that the reference to the lawyer is made with the consent of the Commission and that the security holder is likely to have quite limited access to the lawyer or involvement in the preparation of the opinion.

8.3 We recommend the following addition to section 17:

> *17(6) The Court may, on application by the public issuer, make an order directing any person, but not the person who has required the public issuer to obtain the opinion, to reimburse all or 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.*

8.4 There were mixed views among the respondents to our recommendation. Some agreed with the recommendation. Others were concerned that the provisions application would be too wide and that individuals who had no control over the investigation may, after the event, be ordered to pay costs. We anticipate that the Courts will exercise this discretion with prudence.

9 To remove the automatic prohibition on managing companies.

9.1 Section 382(1)(c) of the Companies Act 1993 provides that where a judgment has been obtained against any person in an action under Part I of the Amendment Act that person shall not take part in the management of a company for five years without the leave of the Court.

9.2 The Commission believes that this provision may be too inflexible, particularly in view of the decision of the Court of Appeal in *Colonial Mutual Life Assurance Society Limited* v *Wilson Neill Limited* [1994] 2 NZLR 152 that liability under Part 1 of the Amendment Act is strict and is not dependent on fault. Moreover, we believe it possible that as a consequence of this section insiders may be prepared to go to extreme lengths to ensure that proceedings are not brought against them under Part I. We recommend that section 382(1)(c) should be revoked.

9.3 Notwithstanding paragraph 9.2 above we think that the Court should continue to have a discretion to disqualify any person against whom a judgment has been obtained under Part I from directing or managing a company. This is provided for in section 383 of the Companies Act. We consider that this provision should remain.

9.4 Generally the respondents agreed with the recommendation. However one respondent was concerned that removing the prohibition on managing companies may be interpreted as lessening the seriousness of the matter.

10 The Commission not to have standing to apply to the Court for orders in relation to insider trading

10.1 In our earlier discussion paper we requested views on whether the Commission should be given standing to bring proceedings. A number of persons who made submissions to us favoured this policy. However, there were certain carefully considered submissions which opposed any change in the role of the Commission. This question raises quite fundamental considerations about securities market regulation generally. What role should the state or state funded entities have in the enforcement of securities rules of law? In what circumstances should the law, in preference, promote and facilitate shareholder enforcement procedures? Where should the line be drawn between the two?

10.2 The Commission has decided, given the policy of the legislation, both the Amendment Act and the Securities Act under which the Commission is established, not to recommend any increase in its enforcement powers. Any such question needs to be addressed separately, perhaps in the course of a more general review of the Commission's role and functions.

11 An objective test for the "Chinese Wall" exception to apply.

11.1 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."

11.2 In general the quality of the Chinese Walls described to us in evidence in various share dealing 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.

11.3 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 recommend that the wording of para (a) of the text be amended to read *"Arrangements existed that could reasonably be expected to ensure ..."*. The effect of this 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.

11.4 In this regard, we note that this recommended amendment is compatible with 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).

11.5 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);

11.6 We do not suggest that an objective test should be prescribed in section 8(1). A 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 an obligation to demonstrate that it was impossible for the company officer by virtue of the procedure to have been able to use 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 recommend that section 8(1)(b) be modified to read:

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

12 Use of "member"

12.1 The term "member" is used on a number of occasions in securities legislation. The term is not defined. The usage appears to have followed the Companies Act 1955, in which the term is also not defined, as a synonym for "shareholder". This usage is consistent with the common law meaning of the term "member".

12.2 The Companies Act 1993 does not use the term "member". Instead it uses the term "shareholder". Amendments were made to securities legislation with the introduction of the Companies Act 1993. On a number of occasions where the term "member of the issuer" appears, this has been replaced by the words "member or shareholder of the issuer", for example, regulation 18 of the Securities Regulations 1983, and the definition of "voting security" in section 2 of the Amendment Act. This has not happened in the case of sections 17 and 18 of the Amendment Act.

12.3 Under Part I it is possible for a person to be found liable for insider trading in respect of dealing in debt or participatory securities. We think the procedural provisions of Part I should allow for this possibility. We recommend that the references to "member" of a public issuer in sections 17 and 18 should be replaced with references to "security holder".

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

13.1 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 inquiries 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.

13.2 It seems desirable to clarify the role of the Commission in relation to market enquiries.

13.3 We recommend 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 power of the Commission under section 10(c) Securities Act to review or comment on any matter in accordance with the general law and that the power is intended to apply in respect of any enquiries into matters arising under any part of the Amendment Act.

13.4 We also recommend that the Commission should have explicit power under section 67 of the Securities Act to request the Registrar of Companies to obtain information to assist it to undertake its statutory role under the Amendment Act.

14 Insider Trading and Share Buy Backs

14.1 Share buy-backs were not generally permitted when the Amendment Act was enacted in 1988. The Amendment Act has unintended consequences for companies which are registered under the Companies Act 1993.

14.2 An issuer may in theory be liable to itself for any gain made or loss avoided when it trades as an insider under section 7(2)(c). This is a problem of logic notwithstanding that other shareholders might have been expected to benefit from proceedings in respect of such a transaction if the Court were to have ordered a distribution under section 19(2).

14.3 Section 60 of the Companies Act is designed to ensure that the board has carefully considered the position and interests of the company and that material information has been disclosed to shareholders in relation to a buy back. We consider that a company should not be liable to itself or to its shareholders under the Amendment Act in respect of buy backs.

14.4 We recommend that the Amendment Act be amended to exclude any liability of the issuer against itself in respect of buy backs.

14.5 We also recommend an amendment to exclude an action against directors of an issuer in respect of:

(a) their involvement on behalf of the issuer in accepting an offer to sell pursuant to a buy-back offer by the issuer; and
(b) advising or encouraging any person to sell pursuant to a buy-back offer by the issuer.

15 **To extend the exception from liability for buying securities under a takeover offer.**

15.1 We observe that an exception from liability of the type available under section 7 by section 8(2) in respect of the purchase of securities which results from a takeover offer is not stated to be extended to liability under section 9 to directors of the issuer or the bidding company who advise or encourage the sale or the purchase of securities pursuant to the takeover offer.

15.2 If directors of a target company, or of the bidding company, recommend to the shareholders that a takeover offer should be accepted, they are advising or encouraging shareholders to sell and may be thought to be liable under section 9 for a gain made or loss avoided by the selling shareholders. This does not seem appropriate.

15.3 We recommend that a takeovers exception of the type contained in section 8(2) of the Amendment Act should be available to exclude actions under section 9 against the target company or the bidding company or their directors or officers, this to be effected by an appropriate amendment to section 10.

15.4 We recommend the following amendment to section 10:

> *10(2) [Exception for takeover offer] No action shall be brought under section 9 of this Act against the target company or bidding company or an insider of either of them which does an act to which that section applies in relation to the purchase or sale of securities of the public issuer if the purchase or sale of securities results from -*
>
> *(a) A take-over offer made in accordance with section 4 of the Companies Amendment Act 1963; or*
>
> *(b) An offer made pursuant to any takeovers code that is in force under section 28 of the Takeovers Act 1993, -*
>
> *as the case may be.*

16 **Other Matters**

16.1 We also consider that there should be a statutory exception in respect of the following types of transactions:

(a) The selling or buying of securities of the public issuer pursuant to-

(i) Any compromise or arrangement sanctioned by the Court under s205 of the CA55 before the 1 of July 1994; or

(ii) Any amalgamation effected under Part VA of the CA55 or Part XIII of the CA93 as the case may be; or

(iii) Any compromise approved under Part VB of the CA55 of Part XIV of the CA93 as the case may be; or

(iv) Any arrangement, amalgamation, or compromise approved by the Court under section 209R of the CA55, including any order made under s209 of that Act or under section 236 of the CA93; or

(v) Any reorganisation or reconstruction of the public issuer that involves all the securities of the same class:

(b) The selling of securities of the public issuer where -

(i) The proceeds are to be used solely to buy rights to subscribe for securities of the public issuer that are offered to all security holders of the same class by means of a current registered prospectus; and

(ii) The sale occurs during the offer period stated in that registered prospectus:

(c) The selling of securities of the public issuer as the result of the acceptance of an offer to buy the securities made by means of an announcement through the Exchange or a stock exchange in any other country on which the securities are listed, being an offer that -

(i) Was made in accordance with the rules of the Exchange or that other stock exchange, as the case may be; and

(ii) Remained open for acceptance for a period of not less than 20 trading days.

16.2 These are all types of transactions which are identified in Procedure II of the Commission's Insider Trading (Approved Procedure for Company Officers) Notice 1996 and earlier notices. The types of transactions were identified after very careful scrutiny and extended public consultation. The effect of the notice is that directors and employees and their families enjoy the benefit of an exception from liability when engaging in transactions of the types under section 7 of the Amendment Act.

16.3 We consider that an equivalent protection should be extended not only to directors and their families, as at present, but to other classes of insiders. We think this should be achieved by statutory means rather than the Securities Commission discretion. Moreover we do not consider it necessary to prescribe a procedure, as required for section 7 to apply, to achieve this effect.

16.4 We recommend that there be a statutory exception from liability under Part I of the Amendment Act in respect of the types of transactions listed above.