

Fundamental changes to insider trading laws among reforms proposed by Securities Legislation Bill

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Roger Partridge - Partner

On 30 November 2004, Commerce Minister Margaret Wilson introduced the Securities Legislation Bill to Parliament.

The Bill includes proposed amendments to the Securities Act 1978, the Securities Markets Act 1988 and the Takeovers Act 1993.

The package of reforms introduced in the Bill includes:

- Fundamental changes to insider trading laws;
- New market manipulation laws;
- Revisions to the substantial security holder disclosure requirements; and
- New rules for the regulation of investment advisers and brokers.

The Bill also proposes amendments to the Takeovers regime.

The most controversial aspect of the reforms is the proposed changes to the insider trading laws.

In introducing the Bill, the Commerce Minister stated that the “current laws are complex, difficult to enforce and its

trading prohibition clauses are relatively easy to avoid”.

The Minister went on to say that “no-one has been found liable for insider trading since the Act came into effect”.

While it is true that the current laws are complex, the proposed new laws are undoubtedly more complex. Whether they result in more convictions or findings of liability will remain to be seen.

Nevertheless, the new package of reforms will almost certainly be introduced during the middle of 2005, and market participants will now need to start evaluating the implications of the proposed reforms.

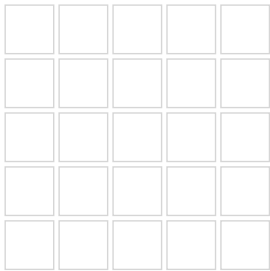
In this newsletter, we provide an overview of the proposed changes to the insider trading laws, explain the proposed new market manipulation prohibitions and outline the revisions to the substantial security holder disclosure requirements.

Proposed insider trading reforms

The Bill proposes fundamental changes to the insider trading laws by adopting a similar approach to Australia.

The proposed reforms involve a significant policy shift. The current insider trading laws are based on a fiduciary concept, concentrating on the insider’s relationship with the public issuer.

This policy basis is replaced with new proposals which focus on the claimed threat that insider trading is said to pose to “market integrity”, rather than a breach of a duty owed to the company.



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Brynn Gilbertson – Partner

Prohibition on insider trading by “information insider”

Under current legislation only principal officers, employees or substantial security holders of a company (and persons who receive information from them in confidence) are insiders of that company.

The proposal extends potential liability to a much wider group of persons.

The insider trading prohibition will apply to any person – described as an “information insider” – who “has material information” that is “not generally available to the market” and who “knows or ought reasonably to know” that this is the case.

Material information

Information is “material information” where:

- “a reasonable person would expect it to have a material effect on price or value if generally available to the market”; and
- this is deemed to be the case if the information will be likely to influence “persons who commonly invest” in deciding whether to acquire or dispose of securities.

The definition comes from the equivalent Australian legislation, and is currently used in the continuous disclosure provisions in the Securities Markets Act 1988 and in the NZX Listing Rules.

Unfortunately, no attempt has been made in the new Bill to deal with difficulties with the definition.

These difficulties are twofold. First, information is either price sensitive or it is not – there is no need for a “reasonable person” test to determine this.

A non-expert “reasonable person” may well expect information to affect the share price in circumstances where the information has in fact already been impounded in the market price.

Secondly, there is no signal given to the court in how it is to determine the difference between “price” and “value”.

It suggests a claim could be made for lost “value” even when information may in fact have had no impact on “price”.

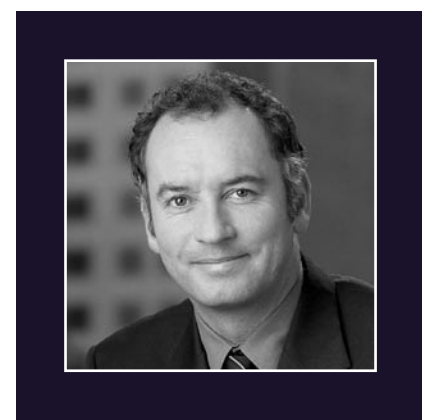
There are also difficulties with the “deemed” definition of material information.

If it is intended to be evidential only, then a court should conclude that information would only ever be “likely to influence persons who commonly invest”; if that information would affect price? However, as Australian commentators have noted, the deeming provision is wider than the first limb and on its fact appears to make the first limb redundant.

The courts will need to determine whether the second limb is inviting investors to reconstruct events and say that information would have made them want to buy or sell?

Effectively, a seller will now have to consider whether it has information which might be relevant to some

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James Gibson – Partner

category of shareholders even if it is not likely to affect the share price.

Generally available to the market

The term “generally available to the market” is also taken from Australian law and is used both in the continuous disclosure provisions in the Securities Market Acts and the NZX Listing Rules.

Information is “generally available to the market” when:

- it has been brought to the attention of persons who commonly invest in securities and a reasonable period for dissemination has passed (the Market Fairness Limb); or
- it can readily be obtained by such investors (by observation, use of expertise, purchase or any other means) or it can be deduced or inferred from such information (the Market Efficiency Limb).

Based on Australian experience, this definition is also proving unworkably vague both for market participants and the courts.

What is a “reasonable period for dissemination” under the Market Fairness Limb? Does it require a trading moratorium? If so, how does that reconcile with market efficiency theory?

Market efficiency theory and empirical evidence indicate that markets incorporate price sensitive information very quickly.

Ordinary investors are protected by information being incorporated into the market price. If so, there is no need for an open-ended dissemination period to protect them.

There are also difficulties in reconciling the Market Fairness Limb and the Market Efficiency Limb.

How can there be a need for a “reasonable period of dissemination”

under the Market Fairness Limb before information is “generally available”; if information is “generally available” once it is “readily obtainable” under the Market Efficiency Limb?

In Australia, this provision has received harsh criticism from the Court. In *R v Firms* in 2001 the New South Wales Court of Criminal Appeal said the two limbs were “a form of legislative astigmatism”.

Additional tipping prohibition

As under the present law, the proposed new laws prohibit an information insider from trading, disclosing information or encouraging or procuring another person to trade (tipping).

In addition, they also prohibit an information insider from tipping another person not to trade.

Civil liability retained

The Act retains, in a modified form, the civil liability provisions of the current Act, which provide for compensation or pecuniary penalties of the greater of three times the “gain made or loss avoided” or the value of the securities traded, together with a range of other civil remedies.

In addition, the present management banning order for a person found liable for insider trading remains.

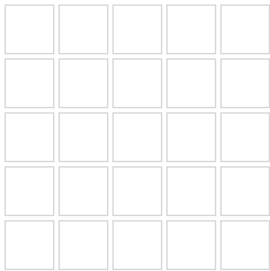
Criminal liability introduced

The significant new feature of the Act, however, is the introduction of criminal liability for New Zealand residents or businesses.

The criminal sanctions provide for imprisonment of up to five years and a maximum fine of \$300,000 for individuals and \$1,000,000 for companies.

Defences

There is an extended range of defences to the new insider trading liability provisions.



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Andrew Brown – Partner

Significantly, however, these do not include the Approved Procedure, which currently permits company directors and executives to trade during designated window periods provided they comply with the procedure approved under the existing Act.

The defences include:

- A takeovers defence
- A defence where the trading or disclosure of information is required by law;
- An underwriting defence (for disclosing, advising or procuring and dealing);
- A knowledge of own intentions defence;
- A broker agency defence;
- A unit trust redemption defence (for buyer and seller only).

There are also new affirmative defences:

- Person trading shares has no knowledge of the trading;
- The information insider establishes the inside information was obtained by independent research;

- The trading takes place on the basis of “equal information”; and
- The trading occurs pursuant to fixed price options or fixed price trading plans.

The existing Chinese Wall defence is retained.

The market manipulation prohibition

The Bill introduces new market manipulation prohibitions.

These involve a comprehensive set of prohibitions against practices involving the creation of a false impression of securities trading activity, price movement or market information.

The prohibitions are consistent with the prohibition on misleading statements and offer documents under the Securities Act 1978.

The prohibition on the release of misleading information applies where:

- A person knows or ought to know information is materially misleading; and
- A statement made is likely to induce a person to trade or have the effect of increasing, reducing, maintaining or stabilising the price of securities.

The prohibition on the creation of false or misleading appearance of trading applies where:

- A statement is likely to create a false or misleading appearance of the extent of active trading or of supply, demand, price or value of security; and
- The person knows or ought to know the information is likely to have that effect.

The Bill proposes the same criminal and civil sanctions as will apply to insider trading.

In addition to the market manipulation prohibitions, the Bill includes a proposed new “general dealings conduct prohibition”.

This prohibits misleading and deceptive conduct in securities dealings. It effectively involves an extension of the prohibition on misleading and deceptive conduct under the Fair Trading Act to a securities dealing.

Liability for this prohibition is strict, i.e. it does not require knowledge.

It applies to listed and non-listed securities and to all dealings (not just trading) including giving investment advice, underwriting, issuing and allotting securities.

Exceptions arise for the following conduct, which is dealt with under other laws or regulations:

- takeovers;
- share buy backs;
- offers to the public; and
- disclosures by investment advisers or broker advertisements.

The sanctions for breaching the general dealing misconduct prohibition are civil only.

The court may make a “compensatory” order or a range of “other civil remedies”. There is no provision for a pecuniary penalty and a management banning order will only be imposed for “persistent contraventions”.

Proposed changes to substantial security holder regime

The Bill also proposes a new set of statutory provisions relating to substantial security holder disclosure.

The definition of “relevant interest” is to be split into three sections:

- A basic rule;
- An extension in respect of powers or controls exercisable through “any trust, agreement, arrangement, understanding”; and
- An extension to interests held by other persons under the control of the person.

The changes to the drafting are largely technical.

The main substantive change relates to the extension of the definition of “power or control” arising through any established “practice”.

This includes “market practices” and “individuals’ practices” in dealing with each other. The extension is designed to catch equity swaps.

No explanation is given in the Bill or the explanatory note about why this extension (which will capture transactions not designed to avoid disclosure) is required. It appears to be a reaction to the *GPG/Perry Corp* litigation.

The Bill introduces the new concepts of “event disclosure obligations” and “request disclosure obligations”. An event disclosure obligation arises:

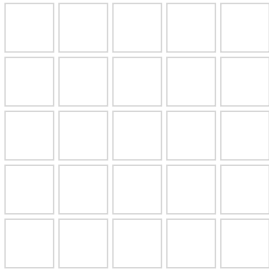
- When a person begins to have a substantial holding (of 5% or more of the shares in a class);
- If there is a movement of 1% in the person’s holdings;
- If the nature of the person’s relevant interest changes; or
- If the person ceases to be a substantial shareholder.

A “request disclosure obligation” arises where the Commission or the public issuer requires a person to disclose to the market any relevant interests or powers to obtain relevant interests that person may have.

“The Bill also proposes a new set of statutory provisions relating to substantial security holder disclosure.”



Peter Castle - Partner



The obligation to disclose information relating to a relevant interest arises even though the person may not be a substantial security holder in the public issuer.

The Commission or the court may make a disclosure order requiring compliance with 24 hours' notice.

The Bill also creates civil liability, including provisions for "compensatory orders"; pecuniary penalties of up to \$1 million, and a range of "other civil remedies" for breach of the disclosure obligations.

A management banning order of up to 10 years also applies for "persistent breaches".

Enforcement and remedies

The Bill contains an extensive codified set of enforcement provisions and remedies.

These include:

- Commission orders;
- Court enforcement orders;
- Civil remedies;
- Criminal offences; and
- Management bans.

The Commission orders include:

- Prohibition orders directed at breaches of market manipulation or general dealing breaches;
- Disclosure orders requiring compliance with the continuous disclosure or substantial shareholder disclosure obligations; and

- Temporary banning orders in relation to investment adviser or broker activities.

The provisions include the codified steps that the Commission must take before making orders.

The Bill also provides that it is a criminal offence for a person to breach a Commission order.

The courts' enforcement powers include injunctions and interim injunctions, corrective orders and disclosure orders, as well as the civil remedy provisions and criminal sanctions.

These remedies exist in addition to automatic or discretionary management banning orders.

The detailed clauses on enforcement and remedies contain a number of unusual provisions relating to the conduct of proceedings under the legislation.

The most significant of these is the proposed relaxation of the rule against hearsay, which permits the court to receive in evidence during civil or criminal proceedings, statements that would not otherwise be admissible.

This kind of provision is not unprecedented in the context of statutory inquiries, but it is unusual to see it extended to deprive defendants in criminal proceedings of the protection of the rules of evidence when they face trial for indictable offences.

Conclusion

The more controversial aspects of the Bill will no doubt receive close scrutiny during the Select Committee process.

It does, however, appear likely that securities market participants will face a number of fundamentally new rules when the Bill is enacted in 2005.

Advice and information

For further advice or information on any aspect of the proposed legislation, please contact any of the Bell Gully advisers listed below.

For further information, please contact your usual Bell Gully adviser or:

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