

New bill proposes tougher securities laws

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David Craig - Partner

A new bill introduced into Parliament last week represents a continuation of recent securities law reform aimed at ensuring confidence in New Zealand’s capital markets. Highlights include specific market manipulation rules, changes to the substantial security holder disclosure regime (addressing the issue in the *Perry* equity swap case), the purported extension of insider trading rules to cover futures contracts, and the imposition of criminal liability for insider conduct.

Outline of the Bill

The Securities Legislation Bill (the **Bill**) was introduced into Parliament on 30 November. It is the end result of the third stage of the Government’s four-stage securities law reform programme. (The final stage is the review of the regulation of financial intermediaries, which a Government-appointed task force is currently conducting.)

Broadly, the Bill does five things:

- it amends provisions in the Securities Act 1978 relating to remedies and the investigation and enforcement powers of the Securities Commission;

- it amends takeovers legislation (most notably by removing the \$20 million threshold test for “specified companies” and “code companies”);
- it amends the provisions in the Securities Markets Act 1988 relating to substantial security holder disclosure and insider trading;
- it introduces new market manipulation laws; and
- it replaces the Investment Advisers (Disclosure) Act 1996 with a new regime for regulating investment advisers and brokers.

This note focuses solely on the last three of these matters. They represent the most substantial, and are likely to be the most controversial, changes to be effected by the Bill.

Securities Markets Act

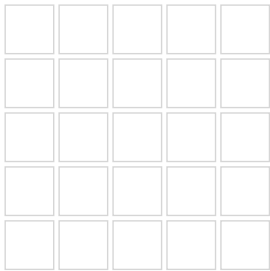
Substantial security holder disclosure

New terminology

The Bill does not change the substance of the current disclosure obligations. However, there is a change in terminology. The Bill introduces new concepts of “event disclosure obligations” and “request disclosure obligations”.

An event disclosure obligation arises when:

- a person begins to have a “substantial holding” (i.e., a relevant interest in 5% or more of the listed voting securities of a public issuer); or
- there is a change of 1% or more in the substantial holding; or
- the nature of the substantial holding changes; or



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- a person ceases to have a substantial holding.

A request disclosure obligation arises when the Securities Commission or the public issuer requires a person to disclose to the market any relevant interest, or power to acquire a relevant interest, in securities. The person to whom the request is made need not be a substantial security holder.

The “Perry” amendment

The most significant change is to the key “relevant interest” definition. Specifically, the Bill extends the definition of that term to include circumstances where a person has a power or control in relation to a security as a result of a “practice.” “Practice” includes market practice and persons’ practices in dealing with each other.

This change was signalled by the Government following the decision of the Court of Appeal in the *Perry* equity swap case (which was the subject of our November 2003 newsletter).

The decision in that case was that Perry, having sold and subsequently re-acquired shares underlying a cash-settled equity swap, did not retain a “relevant interest” in those shares. This was because there was no arrangement or understanding between Perry and its counterparty banks for Perry to re-acquire the shares. The re-acquisition was simply the result of the operation of “market reality.”

The *Perry* case could well have been decided differently if the Bill were law at the time.

This proposed change should be of concern to equity swap counterparties. In particular, it is disturbing that one market participant could acquire a relevant interest from another in circumstances where there is no meeting of the minds between them.

The inherent uncertainty over what constitutes “market practice” will invariably mean that many counterparties will adopt a conservative approach and choose to disclose. Alternatively, other counterparties may seek an exemption from the Securities Commission for equity swaps entered into for financing purposes. The Commission has previously granted such exemptions.

Insider conduct

The perceived ineffectiveness of New Zealand’s current insider trading laws is a well-known fact. No one has yet been held liable for insider trading under the Securities Markets Act.

In an attempt to strengthen the law in this area, the Bill proposes to adopt a regime similar to Australia’s (an approach becoming increasingly common in New Zealand’s commercial law reform).

The new legislation is expressed to focus on the threat that insider trading poses to market integrity rather than (under the current law) the breach of fiduciary duty that the insider owes to the company. Quite what this policy shift will mean in practice is not clear.

The prohibitions

The Bill imposes on “information insiders” a prohibition on certain insider conduct. Specifically, an information insider may not trade, disclose, or advise or encourage others to trade. An “information insider” is a person who:

- has material information relating to the public issuer that is not generally available to the market; and
- knows, or ought reasonably to know, that the information is both material and not generally available to the market.

Liability

The Bill retains the current civil liability rules, under which an insider can be

liable for up to the greater of the value of the relevant securities and three times the gain made or loss avoided.

However, importantly, the Bill also imposes criminal liability on those who knowingly engage in insider conduct. The maximum penalty is five years' imprisonment and a \$300,000 fine for an individual and a \$1 million fine for a company.

Extension of rules to cover futures contracts

The insider conduct prohibitions purport to extend to cover trading in contracts on an authorised futures exchange. The Bill's explanatory note suggests that this will improve the efficiency of, and investor confidence in, the futures markets.

We describe this as a "purported" effect because it seems that the relevant provisions of the Bill do not achieve the clear effect that the drafters intended.

Specifically, the insider conduct rules prohibit trading, disclosure, advice or encouragement in relation to "securities of a public issuer". While futures contracts are now expressly "securities", they are not securities "of a public issuer". By way of example, a futures contract on, say, Telecom shares is not a security "of Telecom".

However, in this respect at least, there is no suggestion that New Zealand should follow the lead of Australia and apply insider conduct rules to OTC derivatives.

Market manipulation rules

Currently, New Zealand has no statutory market manipulation rules other than a little-used section in the Crimes Act 1961 and the general prohibition on misleading or deceptive conduct contained in the Fair Trading Act 1986.

The Bill proposes to make market manipulation a criminal offence, subject to the same maximum penalties as insider conduct (five years' imprisonment and a \$300,000 fine for an individual and a \$1 million fine for a company). The market manipulation rules, like the insider conduct rules, will also cover dealings in futures contracts.

The Bill introduces three market manipulation offences – making misleading statements, causing misleading appearance of trading, and generally engaging in misleading conduct.

Misleading statements

The specific elements of this offence are the making of a statement or the dissemination of information where:

- the statement or information is false or misleading in a material respect;
- the person knows, or ought reasonably to know, that this is the case; and
- the statement or information is likely either to induce a person to trade in the securities of a public issuer or to have the effect of increasing, reducing, maintaining or stabilising the trading price.

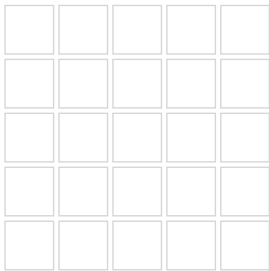
Misleading appearance of trading

The specific elements of this offence are doing, or omitting to do, anything where:

- the act or omission is likely to create a false or misleading appearance with respect to either the extent of trading or the supply of, demand for, or price or value of, securities; and
- the person knows, or ought reasonably to know, that this is the case.

A person will be presumed to have committed this offence in cases involving what is known as "churning" (i.e., trading that results in no change of beneficial

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ownership) or “corresponding trades” (i.e., where two related parties offer to trade on substantially matching terms).

General misleading conduct

The third offence differs from the first two in its generality, in its application to all securities (not just listed ones) and all dealings in securities (not just trading), and in the strict liability it imposes (that is, knowledge is not required). This catch-all offence prohibits a person engaging in conduct, in relation to any dealing in securities, that is likely to mislead or deceive.

Liability for breach of this general prohibition appears to be civil only.

Investment advisers and brokers

The Investment Advisers (Disclosure) Act currently regulates investment advisers and investment brokers. It provides for a two-tier regime of mandatory disclosure and request disclosure.

The Bill will repeal that Act and replace it with a regime that is based solely on mandatory disclosure. Under this new regime, an investment adviser

may not give investment advice, and an investment broker may not receive investment money or property, without first giving the client a disclosure statement.

That statement must disclose matters such as the experience and qualifications of the investment adviser, the investment broker’s procedures for dealing with client money and property, and the nature of any criminal convictions of the adviser or broker.

Territorial scope of legislation

A welcome feature of the Bill is its attempt to outline the territorial scope of its provisions. We are frequently asked by foreign-based financial institutions to advise on the application of New Zealand legislation to financial services provided to New Zealand residents from offshore (typically, via the internet). Often, the legal position is not clear.

The Bill will overcome this uncertainty through express provisions addressing territorial scope. The territorial scope differs depending on the regime in question. For example, the general

misleading conduct prohibition will apply to conduct outside New Zealand by a person resident, incorporated or carrying on business in New Zealand to the extent that the conduct relates to dealings in securities within New Zealand.

On the other hand, the investment adviser and broker rules will apply to services performed for a person in New Zealand, regardless where the adviser or broker is resident, incorporated or carries on business.

Timing

Once the Bill is enacted, its provisions relating to substantial security holder disclosure, and the rules for investment advisers and brokers, will come into force on a date specified by Order in Council (likely to be some time in 2006). The remainder of the Bill will come into force on 1 November 2005.

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

Auckland

David McPherson	david.mcpherson@bellgully.com	64 9 916 8988
Murray King	murray.king@bellgully.com	64 9 916 8971
Richard Hanna	richard.hanna@bellgully.com	64 9 916 8906
Alan McDougall	alan.mcdougall@bellgully.com	64 9 916 8901

Wellington

David Craig	david.craig@bellgully.com	64 4 915 6839
Roger Drummond	roger.drummond@bellgully.com	64 4 915 6994

Auckland

Vero Centre, 48 Shortland Street
PO Box 4199, Auckland, New Zealand, DX CP20509, www.bellgully.com
Telephone 64 9 916 8800, Facsimile 64 9 916 8801

Wellington

HP Tower, 171 Featherston Street
PO Box 1291, Wellington, New Zealand, DX SX11164, www.bellgully.com
Telephone 64 4 473 7777, Facsimile 64 4 473 3845

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