

The Insider Trading Provisions of the Securities Markets Amendment Act 2006

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Introduction

The Securities Legislation Bill was introduced to Parliament on 30 November 2004, heralding significant changes to New Zealand's securities laws. At its third hearing, the Securities Legislation Bill was split into discrete amendments acts to the Securities Act 1978, the Fair Trading Act 1986, the Securities Markets Act 1988, and the Takeovers Act 1993. These were passed on 12 October 2006 and received Royal assent on 24 October.

The suite of reforms includes:

- Fundamental changes to the insider trading provisions of the Securities Markets Act 1988 (the **Act**);
- New market manipulation laws;
- Revisions to the substantial security holder disclosure requirements;
- New rules for the regulation of investment advisers and brokers; and
- Amendments to the takeovers regime.

The most controversial aspect of the reforms is the proposed changes to the insider trading laws. They have far reaching implications. When first introduced into Parliament, the proposed new insider trading provisions were unworkable in many respects. During the period leading up to the third reading of the Bill a number of the key problems identified in submissions to the Select Committee, and subsequently, were resolved by way of a Supplementary Order Paper.

When the Minister of Commerce, the Hon Margaret Wilson, introduced the Bill she stated that the "current laws are complex, difficult to enforce and its trading prohibition sections 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.

Prohibition on insider trading by "information insider"

The new insider trading laws are underpinned by a broadly similar conceptual approach to the Australian provisions. This represents an important policy shift. The current insider trading laws are based on a fiduciary concept, concentrating on the insider's relationship with the public issuer. The new provisions, like the Australian legislation, are underpinned by a "market fairness" approach. This approach focuses on the threat that insider trading is said to pose to "market integrity", rather than a breach of any duty owed to the company.

As a result of this shift in policy 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. This change extends potential liability to a much wider group of persons.

At the same time, the new requirement for knowledge – actual or constructive – in the definition of information insider significantly narrows the category of persons who face liability under the Act. It means that a person who does not know – and who ought not reasonably to know – that he or she have inside information will not be an information insider under the Act.

Material information

As originally proposed, the new section 3 of the Act provided that information was “material information” if a reasonable person would expect it to have a material effect on the price or value of the listed security if generally available to the market. The definition comes from the Australian Corporations Act 2001, and is currently used in the continuous disclosure provisions in the Securities Markets Act 1988 and in the NZX Listing Rules. The original wording provided that this was deemed to be the case if the information would be likely to influence “persons who commonly invest” in deciding whether to acquire or dispose of securities. Unfortunately, no attempt was made in the first draft of the Bill to deal with difficulties with the Australian definition.

First, there was no signal given to the Court on how it is to determine the difference between “price” and “value”. The wording suggested a claim could be made for lost “value” even when information may in fact have had no impact on “price”.

Secondly, there were also difficulties with the proposed deeming provision in the definition of “material information.” This effectively deemed information to have a material effect on price if it “would, or would be likely to, influence persons who commonly invest in securities in deciding whether to acquire or dispose of those listed securities.” That extended definition took the focus of the definition away from the price sensitivity of the information and was inconsistent with the rationale for the prohibition on insider trading. If the information in question would *not* have a material effect on price (which is a factual issue that can be determined relatively easily by expert evidence), there is no reason for the civil and criminal sanctions to apply.

Thirdly, information is either price sensitive or it is not. It makes no sense to include a “reasonable person” test to determine this because the question of whether information would affect the price of a listed security if it were generally available to the market is a question of fact to be determined by expert evidence. The definition of materiality should focus on that issue of fact. There is no room for the introduction of the hypothetical “reasonable person.”

The Select Committee process has led to the removal of two of these difficulties. The reference to the “value” of the securities has been removed. Materiality is now measured solely by the effect on the “price” of the securities. This removes the possibility that information that has no impact on “price” could nevertheless affect the “value” of the company, and so trigger potential insider trading liability. Although this is an improvement to the definition, a difficulty remains regarding how to ascertain the “price” of certain unlisted securities. While this difficulty could have been avoided if the Committee had deleted the “price” rather than “value” limb of the definition, a purposive approach to statutory interpretation by the Courts is likely to lead to the same outcome.

The Select Committee process has also resulted in the proposed deeming provision being deleted, no doubt accepting the submission that it was inconsistent with the new rationale of the legislation i.e. if information is not price sensitive – and so not within the primary definition of “materiality” - then there is no reason for the insider trading prohibitions to apply.

However, a difficulty still remains with what is meant by the “reasonable person” in this context. For example, if information is in fact price sensitive but would not be recognised as such by anyone who is not an expert, is that information not material information because a reasonable person (not being an expert) would not regard it as price sensitive?

If, on the other hand, “reasonable person” means a “reasonable expert,” then the words add nothing and the test should simply have been stated as whether or not the information would have a material effect of the price of the securities if it were generally available to the public.

One consequence of the two changes made as a result of the Select Committee process is the departure from the wording in the equivalent Australian provisions. While this will frustrate the policy objective of trans-Tasman harmonisation, it highlights the shortcomings of an approach to law reform based on copying imperfect Australian legislation.

Generally available to the market

The term “generally available to the market” is defined in the proposed new section 4. Like the definition of “material information”, it is based on the definition in the Australian Corporations Act 2001. It is also currently used in both the continuous disclosure provisions of the Securities Markets Act 1988 and the NZX Listing Rules.

Information is “generally available to the market” when:

- (a) it has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in securities; and a reasonable period for dissemination has passed (the so-called market fairness limb); or
- (b) 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 so-called market efficiency limb).

The wording of the second limb has one important difference from the definition in the Australian Corporations Act 2001. In the Australian Act, information is generally available if it involves a “readily observable matter”. The New Zealand drafters have replaced this concept with the requirement that information must be capable of being “readily obtained” by persons who commonly invest in securities.

The change is a response to a series of Australian decisions involving the ASX listed company Carpenter Pacific Resources NL (Carpenter Pacific). Carpenter Pacific had mining interests in Papua New Guinea. It was involved in litigation before the Papua New Guinea Supreme Court. The Papua New Guinea Supreme Court handed down a decision on an appeal in favour of Carpenter Pacific on 28 July 1995. Mr Kruze was present in the Supreme Court when the judgment was delivered. He telephoned his broker in Australia that day and acquired 800,000 shares in Carpenter Pacific. At the same time a Mr Firms, in Australia, was advised of the judgment by his father, a director of Carpenter Pacific. He purchased 400,000 shares in Carpenter Pacific – in his wife’s maiden name – on the date the judgment was delivered. Three days later, Carpenter Pacific announced the decision of the Papua New Guinea Court through the ASX.

Both Kruze and Firms were subsequently charged with insider trading. They were tried separately. Kruze was acquitted with the Court holding that the delivery of the judgment in the Supreme Court in Papua New Guinea constituted a “readily observable matter” for the purpose of the Australian Corporations Act 2001. *R v Kruze* (unreported, NSWPC, O’Reilly DCJ, 2 December 1999) In contrast, Firms was convicted, with the Court holding that a matter was not “readily observable” unless it was capable of being noticed or perceived *in Australia*. Not surprisingly, Firms appealed the conviction. The New South Wales Court of Appeal by a majority allowed the Appeal. *R v Firms* (2002) 51 NSWLR 548. The majority held that the

concept of a “readily observable matter” was not limited to matters that were readily observable in Australia.

Apparently in response to these inconsistent decisions, the provision that information is “generally available to the market” if it is “readily observable” has been replaced by the requirement that the information must first be “readily obtainable” by persons who commonly invest in securities before it is “generally available”. As a result, an acquisition of shares on the same facts as arose in *Kruze and Firms* will be likely to result in convictions. The implications are that information may be “publicly available”, but because it has not been either “brought to the attention of persons who commonly invest” and is not “readily obtainable” it will not be “generally available” and may therefore remain inside information. This brings about a change from the position under the current law.

More generally, however, the definition of “generally available to the market” in section 4 is flawed and internally inconsistent. The flaw in the definition is created by a combination of two factors. First, any information that falls within subparagraph (a)(i) must necessarily also fall within (b). That is because information that has been made known in the manner that would bring it to the attention of persons who commonly invest in relevant securities must *necessarily* also be information that those who commonly invest in relevant securities can readily obtain. Secondly, the reasonable period for dissemination restriction applies to paragraph (a) but not to paragraph (b). It follows that the reasonable period for dissemination restriction will never apply because any information falling within paragraph (a)(i) will also fall within (b). The point can be illustrated by hypothetical example. Consider the position where information about a listed company is announced at 10.00am and the person trades in the securities of that company at, say, 10.05am. The information may not be “generally available to the market” under paragraph (a) until some (short) period of time after 10.05am given the requirement of subparagraph (a)(ii) for a reasonable period of dissemination. Nonetheless, the information clearly falls within paragraph (b) *immediately* upon its announcement because it is immediately readily obtainable by those who commonly invest in securities.

In any event, the requirement for a “reasonable period for dissemination” sits very uneasily with the manner in which financial information is now communicated through the internet. Whereas it may have made sense to provide for a reasonable period for dissemination when investors were dependent on newspapers or other media reports to obtain news relevant to investors, that makes no sense in an age where information posted on a website is now immediately accessible to all investors. The Australian definitions that are now proposed to be incorporated into New Zealand law in 2005 were first introduced in Australia in 1991 before the commercial development of the internet in the 1990s and are now obsolete. This obsolescence may not raise particular difficulties of interpretation in this instance. It does, however, seem unfortunate that New Zealand should be adopting statutory language that is now out of date.

The insider trading prohibitions

An information insider of a public issuer is prohibited from:

- a) Trading securities of a public issuer while in possession of inside information; and
- b) Disclosing inside information to another person when the information insider knows or ought reasonably to know that the person is likely to:
 - a. trade securities of the public issuer; or
 - b. continue to hold them; or
 - c. advise or encourage another person to trade or hold them; and

- c) Advise or encouraging another person to trade or hold securities of the public issuer (or to advise or encourage another person to hold or trade securities).

The new feature of these prohibitions is the proposed introduction of liability where the disclosure of information, or the advice or encouragement, results in a person deciding to *hold* securities. This feature is not present in the Australian Corporations Act. It also introduces an asymmetry into the prohibitions because there is no prohibition on an information insider *itself* deciding to hold securities where the person has inside information (for obvious reasons). It will raise a number of difficulties in practice: for example it is likely to bring an end to the desirable practice within professional services firms use of “stop” lists to prohibit members of the firm from trading securities where the firm has inside information because the practice will result in a risk of liability for tipping members of the firm to “hold” their shares. This obvious flaw in the proposed change has simply been ignored.

Criminal liability introduced

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

The criminal sanctions provide for imprisonment up to five years and a maximum fine of \$300,000 for individuals and \$1,000,000 for companies. To put the gravity of these sanctions in context, the maximum level of imprisonment is equivalent to the most serious offences under the Tax Administration Act 1994. This accords with maximum term of imprisonment under the Australian legislation.

Civil liability retained

The Act retains, in a modified form, the civil liability provisions of the current Act, which provide for compensation payments, and 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 ban for a person found liable for insider trading remains.

Exceptions and defences

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

Significantly, however, the Approved Procedure under the Insider Trading (Approved Procedure for Company Officers) Notice 1996 is not included. This procedure currently permits company directors and executives to trade during designated window periods, provided they comply with the procedure approved under the existing Act. There is no equivalent protection in the new Act.

The exceptions include:

- An exception where the trading or disclosure of information is required by law;
- An underwriting exception;
- A knowledge of own intentions exception;
- A broker agency exception;
- A takeovers exception; and

- A unit trust redemption defence (for buyer and seller only).

There are also new affirmative defences for cases where:

- The insider does not have knowledge of the trading;
- The information insider establishes that 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.

As introduced at the time of the first reading there were a number of difficulties with these defences. Generally, these difficulties arose because the particular defence did not operate sufficiently broadly. Unfortunately, these difficulties remained after the Bill emerged from the Select Committee. However, a number of the more serious concerns that have been identified were addressed by a Supplementary Order Paper (SOP). These concerns are discussed below.

Knowledge of own intentions defence

In its original form, the “knowledge of own intentions” defence provides a defence to the trading prohibition, but not to the advising or encouraging prohibition. This is a serious problem because, typically, an intending bidder will act on advice from corporate finance advisers and/or officers or executives of the bidder (“the Bid Team”). The problem arises because the “knowledge of own intentions” defence does not include a defence to any advice or encouragement given by members of the Bid Team. Unless this “hole” in the defence was cured before the Bill is enacted, the new Act would unintentionally preclude a range of normal commercial transactions. However, an SOP has addressed this difficulty by extending the “knowledge of own intentions” defence to include advisers acting in a professional capacity.

Shortcomings in the takeover defence

The exception relating to takeovers has been extended as a result of the Select Committee process by removing the anomaly that exists in the current legislation whereby the insider trading prohibitions do not apply to a person who buys or sells shares pursuant to a takeover offer, but do theoretically apply to persons who tip such a person (significantly, the independent directors of the target company who provide a recommendation to shareholders).

While this anomaly has been removed, the changes proposed by the Select Committee to the takeover defence do not go far enough in one important respect. It is common for a target company to agree to allow a party considering making a takeover offer to undertake due diligence. Because of the risk of disclosure of inside information during the due diligence, the target company will generally require an undertaking from the potential offeror that it will not, after undertaking due diligence, trade in the securities of the target company other than under a takeover offer. The difficulty under the existing legislation is that the target company itself can nevertheless be liable for tipping even though the offeror would be protected by the takeovers exception.

The Bill currently attempts to address that issue by providing that the disclosing and advising and encouraging prohibitions in sections 8D and 8E “do not apply if the inside information is disclosed, or the advice or encouragement given, as part of a takeover offer made by an information insider under any Takeovers Code that is enforced under the Takeovers Act

1993". The difficulty with that in the context of due diligence is that the due diligence will necessarily be provided *before* the offer is made (being for the purpose of allowing the offeror to determine whether and at what price to make an offer). As currently drafted, the exception in proposed new section 9E(2) does not protect that disclosure because the due diligence is not provided "as part of the takeover offer."

As with the "hole" in the "knowledge of own intentions" defence, an SOP has cured this defect in the Bill.

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 the market manipulation or general dealing provisions;
- 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 further codify the 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 Court's 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.

43S Evidence not otherwise admissible

The detailed sections 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 proposed new section 43S which carries over the existing relaxation of the rules of admissibility into criminal prosecutions under the Act. Section 43S provides:

In the exercise of its jurisdiction under this Act, the Court may receive in evidence any statement, document, or information that would not be otherwise admissible that may in its opinion assist it to deal effectively with the matter.

This kind of provision – which already exists in relation to civil proceedings under the Act is not unusual in a civil context, 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.

On its face, the section places no restrictions on the power of a court to receive otherwise inadmissible evidence if it would assist the Court "to deal with the matter effectively." Taking a literal approach, this would allow not only hearsay but also illegally obtained evidence and privileged material to be received in evidence. Such a wide-reaching abrogation of privilege and due process would be contrary to basic principles of legality and is unlikely to reflect the legislative intent. It would also cut across the statutory regime governing the Securities Commission. For instance, the Securities Commission's power to require a person to answer questions in the course of an investigation overrides the privilege against self-incrimination under section 69T of the Securities Act 1978. However, under section 69U evidence obtained in this way is not admissible in criminal proceedings against that person. If the evidence was nevertheless admissible under section 43S then the procedural safeguard would be defeated.

Orthodox principles of interpretation will require a rights-centred interpretation - where a person's liberty is at risk, Parliament will not be taken to abrogate rights except by the clearest words, the common law is presumed to apply to the extent that it has not been expressly changed, and section 6 of the New Zealand Bill of Rights Act 1990 provides that "whenever an enactment can be given a meaning that is consistent with the rights and freedoms contained in this Bill of Rights, that meaning shall be preferred to any other meaning."

However, though it is likely that the courts will interpret section 43S as conferring a discretion to receive otherwise inadmissible evidence, it is unusual for such a fundamental change to the normal rules of evidence in criminal proceedings to be introduced without detailed discussion.

The extra-territorial reach of the Act

Section 18 extends the application of the general dealing misconduct prohibition under section 13 (for misleading conduct in relation to dealings in securities) to conduct outside New Zealand to the extent that the conduct relates to dealings in securities within New Zealand.

However, there are no other extra-territorial provisions in the Bill (or in the Securities Markets Act in its present form). Consequently, there is no comparable provision for the insider conduct and market manipulation provisions (under sections 8-8E and 11-11B). This suggests Parliament is of the view that the new insider trading provisions should not have any extra-territorial application given that, the express extra-territorial application of section 13 appears inconsistent with the other prohibitions having effect outside New Zealand.

Conclusion

The changes made to the Bill at the Select Committee stage and by SOP did not go far enough to address the problems identified in the new insider trading regime. Twelve years ago, Adrian van Schie, the author of *Insider Trading, Nominee Disclosure and Futures Dealing: An Analysis of the Securities Amendment Act 1988* (1994, Wellington, Butterworths), remarked of the insider trading rules: "The net has been cast very wide and is bound to tangle the feet of the innocent" (at ix). Regrettably, the new legislation is even more complex and risks the same tangle as the existing laws have created.