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BETWEEN DISCLOSURE AND ABSTAIN: AN ANALYSIS OF THE REGULATORY IMPERFECTIONS IN THE LAW RELATING TO TRADING IN SECURITIES BY POSSIBLE INSIDERS OF A PUBLIC ISSUER

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This paper discusses three areas identified as regulatory imperfections in the framework of insider trading in New Zealand. The first point of discussion focuses on the inherent difficulty in identifying the actual offence of insider trading and the associated difficulties in identifying the elements of the offence. The conclusion reached is that serious evidential difficulties diminish the effectiveness of the proscriptive provisions of the Securities Amendment Act 1988 ("the Act"). The second issue discussed is that commercial reality and efficiency demands a pragmatic application of the Act where possible. The third area of analysis focuses on the inherent problems associated with enforcing the provisions of the Act. The conclusion reached is that the nature of insider trading is such that the only way to successfully address the problem is through centralised action.

The text of this paper (excluding contents page, footnotes, bibliography and annexures) comprises approximately 12,500 words.

"[We] must be mindful that directors are passing judgment on fellow directors in the same corporation and fellow directors, in this instance, who designated them to serve both as directors and committee members. The question naturally arises whether a 'there but for the grace of God go I' empathy might not play a role. And further question arises whether [the court's] inquiry as to independence, good faith and reasonable investigation [of and by the directors] is sufficient safeguard against abuse, perhaps subconscious abuse." *

* *Zaputa Corp. v Maldonado* 430 A 2d 779 (1981), 787

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I INTRODUCTION

Insider trading laws are normally evaluated in terms of their effectiveness at proscribing the occurrence of trading on misappropriated non-public information. The Securities Amendment Act 1988 ("the Act") is designed to eliminate insider trading on securities listed on the New Zealand Stock Exchange. Essentially the Act prohibits an insider who obtains price-sensitive information by virtue of his or her position as an insider from dealing in securities or tipping (recommending the purchase or sale of securities to other traders) until the information is published or otherwise reflected in market prices. Although insider trading is not a criminal offence in New Zealand, the insider is liable to pay damages to the party with whom he or she deals and a penalty to the insider's own company.[1]

New Zealand's framework for insider trading liability is parallel to the Australian legislation in its base premise that market participant should have equal access to material information. The insider in possession of inside information is presumed to have an unfair advantage over other market traders who cannot obtain the same access to information. To remedy this unfairness the premise that there should be parity among market participants is supported and forms the basis of the legislative framework in New Zealand. Essentially the framework prohibits trading based on inside information because possession of the inside information confers an unerodible advantage on the trader. This unerodible advantage if abused creates inequities in the market place. Effectively then the legislation attempts to enforce a framework that achieves parity of information among market participants.[2]

1Section 7(2) Securities Amendment Act 1988

2This feature of insider trading regulation is illustrated by American developments under which the proscription is based on the idea that the insider stands in a fiduciary relationship to market investors and therefore owes a duty to disclose before trading. *Chiarella v United States*, 445 U.S. 222 (1980). *Chiarella* was immediately perceived as not providing sufficient proscriptive framework and accordingly the theory based on the misappropriation of another's information was developed: *United States v Newman* 664 F 2d 12 (2d Cir. 1981)

The focus on achieving parity of information in the New Zealand context can be contrasted with the United States (the "US") position which bases its proscriptive framework on prohibiting misuse of inside information. In the US context liability arises where there has been a fraudulent misuse of another parties confidential information.[3] It is suggested that the basis for insider trading liability is important because it defines the ambit and effectiveness of the proscription. This paper questions whether our legislation in its current form goes far enough to address the real problems associated with insider trading.

The conclusion drawn is that there are regulatory imperfections with New Zealand's current insider trading framework. It is suggested however, that by simply directing the critique to the current regulatory framework, crucial underlying problems not actually addressed by the framework are overlooked. The result is that the effectiveness of insider trading proscriptions are greatly overestimated; in actual fact only targeting a fraction of the types of activities that can create market unfairness and inefficiencies.[4] A further undesirable result is that as prospective participants in the securities market become more aware of the tactics available for evasion of the insider trading sanctions, the existing framework will become increasingly ineffective and irrelevant. To avoid these results, this paper examines the problems with our present regulation of insider trading with particular emphasis on the difficulties associated with tipping transactions.

A study is made of the evidential problems inherent in establishing a successful case. The evidential difficulties are shown to highlight the inconsistencies present in the framework. The paper goes examines the US development of case law under the anti-fraud provisions of the

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[3]Rule 10b Securities Exchange Act 1934

[4]SR Salbu "Tipper Credibility, non informational Tippee Trading, and Abstention From Trading" (1993) Washington Law Review Vol 68, p 315

Securities Exchange Act 1934. The suggestion is made the a pragmatic development of insider trading laws is required in New Zealand to avoid fettering market activity and efficiency. Finally discussion focuses on the difficulties associated with the enforcement within the proscriptive framework. The US framework and its accompanying case law is referred to throughout the paper for comparative purposes.

II REGULATORY APPROACHES TO THE PROBLEM OF INSIDER TRADING

There are two platforms on which to erect a framework for insider trading proscription. The first is that market participants should have equal access to material information; or that parity of information in the market place is desirable[5]. The second is that inside information is presumed to have been produced for the public issuer's gain (not for the gain of the inside trader) therefore the legislation should proscribe the misuse of information by inside traders. The suggestion is that the protection of material price sensitive inside information in this way is in fact essential to market efficiency.[6]

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[5] Informational efficiency of the equity market requires that all information be equally available throughout the market so that share prices reflect the totality of information in the market. (see further Keane, Stock *Market Efficiency* (1983))

[6] A successful regulatory regime must balance the tension that exists between the legislative inclination to regulate everything and the market's preference for minimal government intervention. The guiding principle is "how best to meet public expectations." Market "efficiency" is achieved by promoting investor confidence and increasing participation in securities markets. ie, inspiring the confidence of investors in the fairness and integrity of the market without over regulating and thereby suppressing market responsiveness and creativity. The essence of the argument that insider trading improves market efficiency is the point that all informed trading, regardless of whether the information behind it is public, renders pricing in a large, anonymous marketplace more efficient by expediting the assimilation of a maximum of relevant information. (See further Henry Manne, Insider Trading and the Stock Market (1966), L Stout, "The unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation", 87 Mich. L. Rev. 613 (1988))

A Parity of Information

Parity of information among investors ensures that no one insider has an unerodible advantage over other investors who cannot obtain the same information. Insider trading legislation in New Zealand is based on the premise that insider trading including tipping should be regulated because it preempts or aggrogates[7] a price otherwise available to others.[8] It is suggested however that this analysis is problematic. It is not effective to suggest that insider trading is inherently unfair to other investors on this rationalization and should therefore be prohibited. Does insider trading actually prejudice other investors in the market?

It is often stated that insider trading harms investors and that shareholders should be treated identically. Take for example the following hypothetical. There are 100 shares in Company *A* trading at $10 per share. Insider *A* knows that a takeover will be made the next day at $15 per share. Insider *A* buys 10 shares in Company *A* from party *B* at $10 per share reselling the shares the next day at $15 per share making a gain of $50. The other original shareholders in Company *A* obtain a $5 profit per share on their shareholding. It is difficult to identify who has been injured by the inside trading in this simple example. *B* 's decision to sell was arguably unaffected by what insider *A* knew or failed to disclose; *B* would arguably have pursued its trading plan regardless of *A* 's actions.

Although the insider's trading does have an impact on the supply and demand for the security traded in, it cannot be said that the trading is

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[7]The inside trader has an impact on the supply and demand for the securities traded in; by trading on inside information the insider may purchase or sell securities at a lower buy price or at a higher sale price before the opportunity is afforded to other market participants. The prices are effectively manipulated by the insider trading; in other words a different buy or sell price would have been available to the other investors if the insider had abstained from trading.

[8]Until the relevant information is published or otherwise reflected in market prices, the insider can derive a benefit from the trading on such information; a benefit not available to other security traders.

unfair because the trading distorts the true price of the shares. It is pure speculation as to what price would have been available to investors had the insider not traded. When it is considered that insiders are permitted to preempt a price available to other investors by trading when they are not in the possession of inside information, why should they be prohibited from trading while possessing inside information? The answer and the mischief must lie elsewhere; in the need to protect property rights.

The unerodible advantage held by *A* in the above example; or the abuse to *B* is not *A* 's ability to trade on the information but is simply *A* 's possession of the information and the unauthorized use of it to *B* 's eventual detriment. The policy that insider trading regulation drives off must be to regulate the misuse of inside information to the detriment of other market traders and the public issuer (owner of the information).

B Protection of Inside Information

Material confidential information is valuable. The public issuer is the proprietary owner of the value of the inside information which demands protection. The US experience highlights the mischief inherent in the misuse of confidential information. In *FMC Corp v Boesky*[9] FMC's investment Banker Boesky had secretly advised FMC to increase by $10 the consideration to be offered in its restructuring. On the basis of this information[10] Boesky undertook massive purchases of FMC stock for the purpose of forcing a higher price. Boesky also tipped other investors who made significant purchases of stock. The trading drove FMC stock to a level that did in fact cause FMC to increase the cash amount to be offered, thereby producing a $20 Million gain to Boesky.

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[9]Fed Sec L Rep 92,233 (ND 111 1991)

[10]The law does currently recognise property rights in the type of information which is involved in insider trading cases eg. the advice given by Boesky to FMC. These rights are in legal remedies for disclosure, misuse of confidential information and breach of fiduciary duty.

The case is illustrative of the impact of insider trading and tipping on the property rights of the entity for whose benefit or enterprise the information upon which the insider trades was created.[11] Clearly Boesky used FMC information to his benefit and to FMC's detriment. If Boesky had not traded on the information the stock may not have increased and FMC would not have paid the higher price. Boesky and associates undertook massive purchases of FMC stock for the purpose of causing FMC's management to approve the higher price. The facts support the fact that their purchases accounted for more than 50% of the trading volume during a one month period.[12] The case is illustrative of the tangible harm resulting from the misappropriation of another's information. Effectively FMC incurred a US $220 Million in addition payments incidental to its restructuring as a direct result of Boesky's unauthorized trading.

The United States Supreme Court in *Carpenter v United States*[13] gave a clearly reasoned opinion focusing on the protection of another's information. The case concerned insider Winan and his accomplices who were convicted of mail fraud on proof that they had misappropriated their advance knowledge of the contents of the Wall Street Journal's 'Heard on the Street' column which Winan co-authored for its publisher. The Court emphasised the publisher's interest in the confidentiality of the contents, recognizing this information as a property right capable of protection[14] :

> "Confidential information acquired by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right andbenefit, and which a court of equity will protect through the injunctive process or other appropriate remedy."

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[11] G Walker, B Fisse (eds) *Securities Regulations in Australia & New Zealand* (1 ed, Oxford University Press, Auckland, 1994) 625

[12] Above n11, 623

[13] 484 US 19 (1987)

[14] Above n13, 26

It is suggested that the basis of insider trading regulation should not be justified in the interests of protecting investors or security markets, but rather the property interests in the information's confidentiality.

C The New Zealand Approach

The focus of the New Zealand insider trading framework is clearly on ensuring that there is parity in the market and thereby protection for investors. For example on the facts of *Boesky*, the focus of Boesky's liability would be on 2 limbs. First whether Boesky was an insider and secondly whether the information was inside information. If these 2 limbs are not satisfied, Boesky would bear no liability. The analysis is concerned to prevent Boesky (insider in possession of inside information) from trading on a more advantageous playing field then other market players.

In the New Zealand context liability does not depend on whether there has been an adverse dealing with confidential information to the detriment of the owner of the information. Furthermore there is no consideration as to whether disclosed information actually breaches fiduciary obligations. The considerations focus solely on prohibiting an insider from trading on inside information thereby ensuring that all investors are trading on the same level; rather than whether proprietary rights in the information should be protected.

It is submitted that because of its focus the New Zealand regime is significantly limited and indeed inadequate to deal with the potential abuses of proprietary rights. To illustrate this, the following is an analysis of some of the startling problems in New Zealand's present regulatory framework. Essentially there are three areas of difficulty. First the problems associated with detecting the offence.

The evidential problem in establishing that tipping activity has occurred in some instance is shown to be insurmountable. Because of

the evidential difficulties, some areas of inside trading are not adequately addressed by the proscriptive framework. Secondly the problems associated with implementation of the legislation are addressed. On inspection of the US development in relation to the anti-fraud legislation, the suggestion is made that concerted effort must be made to ensure that the New Zealand regime develops in a commercially sensible manner. Thirdly the problems associated with the enforcement of the statutory framework are examined in light of recent New Zealand decisions. The suggestion made is that the present regime is inadequate to deal effectively with insider trading activity. Suggestions are offered as to possible approaches that could be considered to deal with the regulatory imperfections identified.

III THE PROBLEMATIC NATURE OF THE CURRENT REGULATORY APPROACH

A *Difficulties in Establishing the Elements of Insider Trading*

1 *Tipping: The nature of the tip*

A corporate insider owing a fiduciary duty to the company (either as a principal officer, employee or substantial security holder) is bound by the duty to abstain from trading on inside information.[15] A tippee (a person who receives inside information from a person having a fiduciary relationship with the public issuer) is liable for trading only if the information is received in confidence.[16] If information is received in confidence, the receiver is considered to be an "insider" and is therefore liable (other requirements being fulfilled) to the provisions of the Act. Arguably the requirement that the information

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[15] An insider's liability for dealing is in section 7 of the Securities Amendment Act 1988

[16] An insider's tipping liability is found in sections 9 and 13 of the Securities Amendment Act 1988

be received in confidence for insider trading liability to arise reflects a policy that the framework should not be too concerned with preserving macro level market integrity but should focus on specific transactional fraud.[17]

Take for example the following hypothetical. One Saturday while watching a rugby match from the sideline *A* inadvertently overhears *B* relaying sensitive inside information to *C* in respect of a takeover of Company *X*. Because A overhears the information in a public place, *A* is not liable for trading on that information particularly as the information was not imparted to *A* with the necessary degree of confidence. The insider trading laws are not concerned with restricting *A* 's use of the information because *A* is not an "insider" or one receiving the information in confidence. As a result the blatant misuse of another's confidential information is left unsanctioned. *A* cannot be sued and even though *A* may be holding all the trading profits, *A* will be entitled to keep them.

If *C* were to trade on the other hand, *C* would have the same liability as *B*, both parties falling within the definition of "insider". Ironically however *B*, the party who simply tipped freely without deriving any advantage from the tip will be significantly worse off than *C* who in fact trades. *C* having traded and profited will effectively be returned to *C* 's original position by having to compensate by returning trading profits. Any liability and corresponding compensation required from *B* however is effectively a penalty because *B* would not have collected any profits which could be used to compensate any injured party.

2 The "in confidence " requirement : Evidential difficulties

As alluded to above where there is no fiduciary relationship between the giver and the receiver of the information, the crucial question is

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[17] Above n4, 312

whether the information was communicated in circumstances importing an obligation of confidence.[18] It is suggested that no obligation arises if the giver of the information does not intend that there should be any obligation of confidence imposed on the recipient of the information. Take for example a case where information is provided by a company to a financial analyst in the full knowledge and expectation that the analyst would use the information freely. In this example, no obligation would attach to the analyst. If on the other hand the company gives the analyst the information and there is a general expectation that the information will not be published generally, the analyst may be at risk if he or she trades prior to the information becoming public.

There is a fine line to be drawn and whether or not liability attaches; liability will depend strictly on the context in which the information is received. Because of the requirement that information be received in confidence, the ambit of liability is significantly limited because of the difficulties of proof. Essentially the "in confidence" requirement limits the ambit of liability creating insurmountable evidential difficulties.

The defect in the New Zealand proscriptive framework is that it does not provide a means to compel the requisite evidence. The single most important aspect of the Securities Exchange Commission's ("the SEC") enforcement power in the United States is its broad ability to obtain information from anyone in the United States.[19] Once a matter is identified as appropriate for investigation, there is no impediment, except for privileged communications and the right against self-incrimination, that will hamper the SEC's ability to get to the evidence it seeks.[20] Unlike the US regime, the New Zealand regulatory system

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[18] *AB Consolidated Ltd v Europe Strength Food Co Ptd Ltd* [1978] 2 NZLR 515

[19] Michael D Mann, "What Constitutes a Successful Securities Regulatory Regime?" Australian Journal of Corporate Law Vol3. No.2 185

[20] Above n19,185

does not have the tools to effectively identify and gather the evidence necessary to prosecute insider traders.

3 *Practical illustrations of difficulties of proof*

A US case that illustrates the difficulties of proof inherent with the "in confidence" requirement is *United States v Chestman.*[21] In that case, Ira Waldbaum and his family, who owned 51 % of the stock of Waldbaum Inc. entered into an agreement to sell all their stock to the A & P supermarket chain for $50 a share, on the condition that A & P then make a tender offer for the remaining stock at the same price. Before the agreement was publicly announced, Ira told his sister Shirley, who in turn told her daughter Susan, who in turn told her husband Keith, each telling the other not to tell anyone outside the family because that "could ruin the sale." Keith called his broker Chestman and told him that he "had some definite, some accurate information" that Waldbaum was being sold at a "substantially higher" price than the current market and asked Chestman what he should do. Chestman was aware that Keith was married to a Waldbaum niece. During the morning, Chestman purchased 11,000 shares of Waldbaum stock for himself and his discretionary accounts at prices ranging from $24.65 to $26 a share. When the tender offer was announced later that day, the price of Waldbaum stock rose to $49 a share. Chestman was convicted of violations to insider trading Rule 10b-5.

The conviction was reversed on appeal. The court held that evidence that Keith Loeb revealed the critical information in breach of a duty of trust and confidence known to Chestman is essential to the imposition of liability on Chestman as tippee. Such evidence was lacking on the facts of the case. Although Chestman was aware that Loeb was a member of the Waldbaum family there was simply no evidence that he knew that Loeb was imparting the information in

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[21] 903 F.2d 75 (2d Cir. 1990)

confidence. The facts of the case highlight the obstacles to proving the requisite "in confidence" element of a tipping action.

To more clearly illustrate the inconsistencies inherent in tipping liability consider the following simple hypothetical ("case one"). Director *A* is an insider of Public Issuer *X*. Director *A* is friends with and plays golf with Outsider *B*. While out playing golf one day A discloses to *B* that a formal takeover offer has been put to *X*. The price offered for the shares of X is in fact $5 per share above market value. On receipt of this information B purchases 1000 shares in *X*. *B* makes an off market transaction through *B*'s broker. The broker records and share transfer subsequently show that *B* purchased shares from *C* (shareholder of *X*). Following the takeover *B* sells the shares and profits. *C* meanwhile is indignant. Had *C* known of the proposed takeover, *C* would not have sold the shares prior to the takeover to *B*. Although *C* received market price for the shares, *C* did not receive the price that would have been received had full disclosure been made. *C* decides to pursue and action under section 7(2)(a) of the Act.

C's case is that *B* is an insider under section 3(1)(c) of the Act having received inside information in confidence from *A* (a principal officer of the public issuer). Under section 7(2)(a) of the Act an insider of the public issuer is liable to persons who sell securities to that insider and incur a loss. *C* therefore has a potential claim against insider *B* under section 7(2)(a). There are however, significant and it is suggested insurmountable problems of proof that effectively stop *C* from succeeding in any claim against *B*. In order to satisfy the elements of liability *C* would have to prove not only that *B* received inside information from *A*, but that *B* received the information in confidence. It is unlikely that *C* will be able to fulfil these critical elements of proof. Neither *A* nor *B* are likely to divulge to *C* the circumstances in which the information was passed. Essentially then,

B has no recourse under section 7 against the tippee; the tipping activity in this instance goes unchecked.[22]

Additionally *C* has a direct cause of action against the *A* as tipper pursuant to section 9(2)(a) of the Act. The elements *C* must prove to be successful however are also impractical if not impossible. *C* must prove that *A* advised or encouraged *B* to buy the shares[23] or alternatively that *A* communicated the information to *B* knowing or believing that *B* would buy the shares.[24] It is doubtful that *C* will be able to ascertain the requisite evidence to satisfy the liability requirements of section 9. How would *C* be able to prove that *A* advised or encouraged *B* to purchase shares? Even more problematic, how is *C* able to prove that *A* communicated the information knowing that *B* would purchase shares?

4 Inconsistent results

The above analysis highlights the difficulties inherent in proving the elements of a tipping action. It is suggested however that the difficulties of proof are not intractable in every tipping scenario. Take for instance the following hypothetical ("case two"). A is a director of Public issuer *X*. A formal offer has been made to *X*. *A* formally instructs X's solicitor *B* to provide ongoing advice in relation to the takeover. Privy to the takeover offer and the subsequent valuations and realising that the takeover offer is significantly above market value, *B* purchases shares in *X*. *B* in fact purchases off market through a broker and in fact purchases C's shares. What cause of action does *C* have in this case?

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[22] The tipper and tippee as insiders are also liable to the public issuer under section 7(2)(c) however it is unlikely that the public issuer will be successful in any claim because of the same difficulties of proof.

[23] Section 9(1)(a)

[24] Section 9 (1)(b)

Once again C's case is that *B* is an insider under section 3(1)(c) of the Act having received inside information in confidence from *A* (a principal officer of the public issuer). *C* therefore has a potential claim against insider *B* under section 7(2)(a) if *C* can prove that *B* received inside information from *A* in confidence. In this case, there would probably be a record of instruction to *B* which would confirm that *B* received information from *A*. Also the fact that the information was passed in confidence could be satisfied on the facts.

Unlike the previous scenario, in this case *C* will probably be able to satisfy the critical elements of proof in this case and therefore has recourse under section 7 against *B* for any loss *C* incurred on the sale of shares. Unlike case on in this case *C* would not have an additional cause of action against *A* as tipper under section 9 of the Act. It is unlikely that *C* will be able to assert that *A* either advised or encouraged *B* to buy shares or that *A* communicated the information to *B* knowing that *B* would buy shares.

The above hypothetical cases highlight the inconsistencies in the treatment of tipping activity under the present framework; inconsistencies that arguably produce inequitable results. In case one *C* has no cause of action against either the tipper or the tipper both of whom are insiders. In case two however, *C* may have a cause of action against the tippee. Is the rule against tipper trading proscribed in sections 7 and 9 of the Act appropriate given the inconsistency that arises from its application?

Arguably it is simply a fact that it is easier in some liability cases than other to prove the elements of liability. The theory is that it should be easier to prove the elements of a case in a case of greater abuse; public policy requires it to be so. Arguably as a matter of policy case 2 above highlights the abuse that the proscription is attempting to inhibit; accordingly the inconsistency can be justified on policy grounds. In other words the inconsistencies may the theoretical and indeed insignificant if we consider that case 2 represents a greater abuse; and accept that the legislative proscription although unable to

effectively proscribe all abuses does adequately address the greatest problem.

5 Impotent system?

The present framework clearly does not allow an aggrieved shareholder to recover from another investor who has abused inside information. Essentially, the present tipping regime does not achieve the goal of parity of information between market investors because *B* who is in possession of advantage cannot be penalised or prohibited from trading with an advantage. The injury to *C* is a direct result of there not being a process by which the evidential requirements for the action to can be obtained. Although there is a regulatory system in place, the system is dysfunctional as a result of the evidential problems. The framework which is arguably based on the premise that investors should have equal access to information has failed to address certain situations where there has been an abuse of position resulting in unequal access to information. Can the problems with the present system be corrected?

6 Change of focus required?

It is suggested that if the focus was to shift from a system striving to achieve parity among market participants to one which sought to proscribe the misuse of information, the framework may not appear as defective. If the focus was on misuse of information what would the framework be proscribing? Arguably the proscription would be against injury to the owner of the information by the *misuse* of that information. In the above hypothetical cases, arguably there is no injury to *X*. The trading by *B* does not effect *X* even if the trading was by an insider on the basis of inside information. The only injury was to *C*, which is of little importance or concern to *X*. In this light, the resultant inconsistencies and evidential difficulties are redundant.

B Difficulty in Detecting the Act of Insider Trading

1 On market versus off market transactions

As illustrated by the two hypotheticals above, there are significant proof problems that an aggrieved shareholder must overcome to succeed with actions under sections 7 and 9 of the Act. It should be emphasised that the examples used however are one that involve off market transactions where the counterparty to the transaction could be identified. Even with this advantage the difficulties in the first case are insurmountable. If the transactions involved on market dealing it would be virtually impossible to detect the relevant counterparty to even begin to consider the elements of proof. To some extent the difficulties associated with on market transaction are discussed below.

Present liability focuses on injury to a particular party in a transaction rather than market break down that may result from unidentifiable transactions. [25] Focus on the elements of a particular transaction is limiting because of the increasing difficulties associated identifying a cause of action. Significant logistical issues surround the successful prosecution of insider trading cases because the market place naturally depersonalizes exchanges making counterparties to transactions anonymous.[26] The US framework is less restrictive in allowing those who trade contemporaneously with the defendant (in the relevant shares) to have a civil cause of action against the defendant provided they can prove the basic element of fraud. The New Zealand situation is more complex as illustrated by the experience of one shareholder in the recent *Wilson Neill*[27] case.

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[25] See further Jeffrey P Strickler, "Inside Information and Outside Traders: Corporate Recovery of Outsider's Unfair Gain", (1985) 73 Cal L Rev 483,510

[26] Not only is there difficulty in identifying counterparties, difficulties arise in identifying inducement, proving causal nexus between a defendant's acts and the plaintiff's ostensible injury

[27] *Colonial Mutual Life Assurance Society Limited v Wilson Neill Limited* (No.2)(1994) 7 NZCLC 260,401 (CA)

2 *Colonial Mutual Life Assurance Society Limited v Wilson Neill Limited*

The *Wilson Neill* case concerned share dealings (the "dealings") in 1990 and 1991 in the Company Wilson Neill Ltd (the "Company"). The Company had diverse interests; liquor interests in Australia and New Zealand. Before the dealings Magnum (now DB Group Ltd, a publicly listed Company) held through its subsidiaries around 27% of the shares in the Company. Colin Herbert, the Company's chief executive owned/controlled 20% of the shares in the Company.[28]

Magnum and Herbert entered into negotiations in relation to a joint venture agreement with a view to combining their interests in the Company. The plans for a joint venture fell through and instead it was decided between the parties that Magnum would purchase 61 million of the Herbert Group's shares while the remaining 14 million shares were made subject to a put option in favour of the Group whereby Magnum was required to purchase the remaining shares between 15 and 31 July 1991.

The price to be paid for the Herbert shares was 65 cents per share.[29] Magnum discovered soon after that the Company was in much worse a position than earlier thought. Interim financial statements for the year ended 31 March 1991 showed a small net profit of only $4 Million. A financial report was commissioned from Southpac Corporation Ltd which painted a bad picture. Having partially paid for the 61 million Herbert Group shares and having been advised that there was no course of action against the Herbert Group, Magnum completed the purchase of the 61 million shares but canceled the put option. The 14 million shares, the subject of the put option were placed on the market. Various institutional and other investors bought shares at

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[28] Herbert controlled much of his shareholding through various companies

[29] At the time shares in the Company were being traded at around 60 cents per share

around 40 cents.[30] The price of the shares fell steadily to as low as 10 cents by the end of 1991. A group of shareholders in the Company sought leave to exercise the public issuer's (Wilson Neill Ltd's) right of action against perceived insiders in the Company under section 18 of the Act.

As stated previously the difficulty that faces an aggrieved shareholder is that there must be proof that they are the counterparty to the inside trading or tipping. In the *Wilson Neill* case, one private investor Brian Gaynor, investment analyst of Auckland documented the delays and problems associated with the shareholder remedy provisions of the Act.[31] The Gaynor situation in the *Wilson Neill* case is illustrative of the difficulties in this respect.

Gaynor purchased all his holding on the market through brokers Buttle Wilson who in turn purchased from Fay Richwhite Equities.[32] Gaynor was unable to determine who the counterparty to his transactions were as Fay Richwhite Equities refused to disclosed the identity of the sellers. This resulted in am impasse[33] as far as Gaynor's determinations were concerned. The Securities Commission were asked to identify whether Gaynor had indeed purchased from insiders. The Commission stated that the counterparties to Gaynor's transactions were not insiders and therefore Gaynor had no cause of action as an aggrieved shareholder.

The Young investigation confirmed this position. Yet over a year later, Gaynor received advice from Buttle Wilson that the counterparty to his transaction was indeed an identified insider and that compensation would be forthcoming. The result is a confused

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[30]The market price of the shares had been falling and was about 40 cents at the time of the cancellation and the placement in July 1991

[31]See "Securities Commission should take a more Proactive Stance" The National Business Review, New Zealand, 2 June 1995, p64-65

[32]Above n31, 65

[33]If Gaynor had not had the support of other institutional shareholders and had been successful in the section 17 request, the matter might have been halted at this point.

situation and unacceptable delay in redressing the situation. The confusion and delay result from the inherent practical difficulty in determining counterparties to insider trading transactions.

There are two methods for determining the counterparties to a share transaction. These are the share registry and the sharebroker reconciliation methods.[34] The Securities Commission has stated that the sharebroker reconciliation method is the most accurate method of determining counterparties to a share transaction:[35]

> "In our view, the broker records which are drawn up on the day of the transaction, or on the day after, are a more reliable record of counterparties to a share trade than registry records which tend to be entered a week or more later."

Gaynor received compensation in June 1994 some 4 years after the transactions involving insider trading. As noted by Mr Gaynor, the payment received is little compensation for the expenses incurred over the past 4 years pursuing the case.[36] The present framework leaves the enforcement of the provisions of the Act to the aggrieved shareholders. Given the difficulties associated with actually identifying the parties to the activity it is clear that the framework is inefficient in its present form.

C Commercial Reality Requires a Pragmatic Approach to Liability

1 Rule 10b-5 Securities Exchange Act 1934

The proscriptive framework for insider trading activity in the United States is illustrative of a pragmatic approach to insider trading. In the United States there is no specific insider-trading statutory provision. Rather, insider trading is regulated by a general anti-

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[34] Above n31,65
[35] Above n31,65
[36] Above n31,65

fraud statutory provision, Rule 10b-5 of the Securities Exchange Act 1934 which provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) to employ any device, scheme, or artifice to defraud,
>
> (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

Because there is no specific insider-trading statutory provision in the United States, insider-trading law has developed through case-law which has interpreted Rule 10b-5. By way of example, in relation to tipping activity the US Court have indicated that tipping is only an offence if it is improper i.e., the tipper expects a personal profit or other benefit from the tipping.[37] The New Zealand legislation does not have the equivalent of Rule 10b-5 which is essentially an all encompassing anti-fraud provision under which most American tipping and insider trading prosecutions occur.[38] It is suggested that if the New Zealand regulatory system is so statute based there is a danger that market activity being shackled. A pragmatic approach is required to loosen the bindings.

2 *Market activity fettered*

It has been suggested that the insider trading proscription in New Zealand is "pernicious to the efficient operation of the capital market."[39] This suggestion is made on the basis that our framework

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[37] *SEC v Dirks* 463 US 646 (1983) 662

[38] Above n11, 633

[39] Above n11, 632

does not restrict liability to where the trader violates a duty to the owner of the information. Once again if the tipping scenario is taken, the wrongfulness of the tipping action does not depend on whether there has been a misuse of inside information belonging to the public issuer. Liability arises if the tipper either advises or encourages another to trade or communicates the information with the knowledge or belief that the tippee will trade. Unless a pragmatic approach to liability is taken market activity may be significantly hampered. To illustrate this proposition, consider the following.

Take the common occurrence of Company executives meeting with investment analysts to discuss the company's performance. In the US case *SEC v Bausch & Lomb Inc*[40] Shulman, the Company's chief executive officer was prosecuted for negligently revealing to analysts the negative impact that problems with one of the company's products would have on the company's performance. For weeks the company had been asked by analysts for an indication, and due to either fatigue or inadvertence, Shulman disclosed the information. The disclosure caused a rash of trading by the analysts and their advisees. The S.E.C's prosecution was unsuccessful because the Court held that negligent misconduct was not proscribed by Rule 10b-5.

In comparison the New Zealand framework does not distinguish between different types of conduct. Our framework does not take into account the wrongfulness of any action because the focus in not whether there has been a breach of fiduciary duty or detrimental use of confidential information. By revealing the information arguably Shulman was prima facie advising investors to account for the impending problems the Company was to face. Irrespective of his negligence or the context in which the information was given, in the New Zealand context Shulman would be liable for tipping.[41] Moreover

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[40] 420 F Supp 1226 (SDNY 1976)

[41] In the New Zealand context the words "advise or encourage" can be construed widely. The Securities Commission has considered that the fact that a person was regularly consulted on share purchase details and kept up to date on the price of the shares meant that that person could be regarded as a person who advised or encouraged a purchase. (See Securities Commission, "Report on

the analyst would be liable as tippees arguably having received information in confidence from an insider and trading on that information.

Tipping activity is sanctioned on the basis that parity of information in the market must be maintained. This policy simply sanctions tipping of inside information without any gloss. If the emphasis were to shift and instead the issue became whether or not a fiduciary relationship had been breached by improper disclosure, consideration could be given to the nature of the tipping activity. In the *Bausch & Lomb* case, the consideration would focus on whether Shulman's actions were negligent and possibly outside the ambit of insider trading liability rather than simply whether Shulman tipped.

3 Takeover Notice

The takeover situation is another example of the problem of achieving market efficiency while working within the regulatory framework. Difficulties arise when the directors of Public issuers, which are either potential offerors or targets of planned takeovers, discuss with shareholders the hypothetical but possible takeover situation. Take the example of Public Issuer *A* which is planning a takeover of Public issuer *B*. The directors of *A* make an offer to B's Board. During the course of negotiations B's directors disclose price sensitive information to *A*.[42] *A* makes a bid for *B* under the Companies Amendment Act 1963. While directors of *A* may have a defence to any tipping liability, the directors of *B* will be liable for tipping in light of the information they made available to the bidder and their advisers.[43] The liability arises in that the directors of *B*

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enquiry into dealings in the voting securities of Gulf Resources Pacific Limited (formerly City Realties Limited) during the period November 1989 to January 1990," June 1992, para 9.5)

[42]Example refers to the takeover notice required by the Companies Amendment Act 1963

[43]Arguably Directors can simply avoid tipping liability by simply releasing the information on which they base their recommendation. As discussed below at note 61 if deals are being done based on non-public information maybe as a policy consideration the level of disclosure should be raised.

disclosed sensitive information to *A* knowing that *A* was likely to buy securities in *B*.[44]

Moreover the directors of *B* may find themselves in the predicament of recommending a course of action to their shareholders in respect of the offer from *A*. If the price offered by *A* is in their opinion reflective of the worth of the company the directors of *B* may recommend that the shareholders sell. This recommendation would constitute advising or encouraging shareholders to sell and hence tipping liability will attach to the directors of *B*. The inefficiency of the situation is compounded when the Securities Commission assumes that directors will be in a position to see the interests of shareholders in takeover situations[45], a position which is clearly compromised.

If the directors advise the shareholders that the offer is particularly beneficial to the shareholders, given what they know, the directors will be liable to the bidder company. Alternatively, no liability will attach in this respect if the offer is detrimental to the shareholders. However, in the latter instance , the directors surely owe a duty to disclose relevant information to the shareholders. The directors are effectively on the one hand trying to avoid tipping liability to the bidder and on the other hand trying to meet the fiduciary obligations owed to the Company. It has been suggested that the only safe course for the directors to follow is to make no recommendations whatsoever.[46] Clearly this course of action is impractical given that the realities of the situation require "open" discussions between all parties. Safeguards which are lacking under the present framework must be developed which protect the interests of the companies involved while also facilitating discussion between offeror and offeree. While it is desirable that the net protecting inside information is widely cast the proscription should not threaten

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[44]section 9(a)(b)(i)

[45]See Securities Commission, "Insider Trading- Report to the Minister of Justice" (2 Vols), December 1987, para. 8.2

[46]A Van Schie Insider Trading, *Nominee Disclosure and Futures Dealing: An analysis of the Securities Amendment Act 1988* (1 ed, Butterworths, Wellington, 1994) 25

corporate executives with prosecution for tipping if they wish to facilitate commercial transactions by open dialogue with the investment community. Achieving the balance is crucial to market efficiency.

4 Call for a pragmatic approach

It is suggested that the development of the New Zealand regime must be sensitive to market realities.[47] Market activity may be significantly impeded by the proscription of selective disclosure of price-sensitive information to professionals like analysts if too fixed an interpretation is placed on the statute. At present there would appear to be little room to consider whether the information the subject of the selective disclosure (effectively tipping) is improper and therefore proscribed. Consideration should allow determination to be made as to whether the person making the disclosure (the tipper) expects a personal profit or other benefit from the disclosure thereby making the disclosure improper and illegal. Instead New Zealand attempts to maintain the parity of information objective by presently proscribing all disclosures to analysts of inside information.

It is suggested that market efficiency requires that pragmatic approach is taken particularly with respect to selective disclosures falling under the proscriptive ambit of tipping; one which embraces the views taken by the Supreme Court in *Dirks*. The US Supreme Court noted in *Dirks* that:[48]

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[47]The Australian legislation is also broad in its proscription however it is notable that the Courts have also taken a pragmatic approach in resolving cases. In *Hooker Investments Ptd Ltd v Baring Bros Halkerston & Partners Securities Ltd & Ors* Aust. Sec. L Rep (CCH) 76,105 (N.S.W. Ct. App. 1986) insider trading was alleged to occur because an issuer had disclosed non public financial forecasts to a group of underwriters in advance of a new offering of its securities. Although this activity was clearly in breach of the proscription against the selective non disclosure of price sensitive information to one believed to trade on that information, the Court resolved the case on a defence that no insider trading violation occurs if the counterparty is aware of the non disclosure.

[48]463 US 646 (1983) 662

> "Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of the market analysts, which the S.E.C itself recognizes is necessary to the preservation of a healthy market. It is common place for analysts to "ferret out and analyze information" . and this often is done by meetings with and questioning officers and others who are insiders."

5 *Enlarging the application of pragmatic approach*

Virtually all recent insider trading cases in the US focus on transactions based on factual information rather than hints or suggestions resulting in advantage. There are few US cases to date where the defendant has been held accountable for trading on the opinions or the credibility of an insider even if that insider's tip, opinion or credibility has been founded on undisclosed inside information.

Consider the following hypothetical. Public Issuer X's financial executive (insider A) is aware that X has recently made an important technological discovery . Insider *A* receives a telephone call from an outside investment analyst, *B*. *B* wants information from *A* regarding the present financial health and future prospects of X. In the course of their discussion *A* comments explicitly on publicly available information; evaluating that information as well as publicly unavailable information based on experience and expertise. Last year before the discovery *A* had projected to *B* a realistic but constrained forecast of the Company's performance. This year, while constrained by the need to keep information concerning the discovery a secret and also confined by securities laws, *A* nevertheless communicates to *B* the "spirit" of the new discovery in summarizing X's financial position. While clearly *A* has made an important unlawful disclosure to *B*, benefiting *B* and *B* 's clients, does any liability for insider trading hang on *A*? Has any real information passed between the

parties? It is suggested that the injury to X and other market investors is the same whether or not there has been an unlawful disclosure of factual information or veiled information. Both types of information are indistinguishable on principal and should fall equally within the definition of "inside information" under section 2.

The New Zealand Securities Commission in its Report on the Affairs of Regal Salmon Limited[49] addressed the issue as to what extent deductions or inferences drawn by a recipient from information of a very general nature provided to that recipient would come within the meaning of inside information. The Commission suggested that in considering the issue the Courts should be guided by the Appellate Court pronouncements of McInerney J in *Waldron v Green*[50]:

> "Our section does not require that information be "specific". In many cases a hint may suggest information or may enable an inference to be drawn as to information. Information about impending stock movements or share movements may often be veiled. Discussion concerning such movement may often take the form of "mooting" but not deciding the matter."

Further the Commission noted a commentators view that:[51]

> "...although the information which has motivated trading must be something more than a hunch or a shrewd or educated guess, any opinions, predictions, deductions, and suchlike perceptions capable of being made only by an insider will be sufficient..."

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[49]New Zealand Securities Commission Report of an Inquiry into Aspects of the Affairs of Regal Salmon Limited including Trading in its Listed Securities, Securities Commission Wellington, 28 July 1994, 117, p159

[50](1977-78) CLC-CCH 29728 at 29733

[51]Bennetts, "Regulation of Insider Trading: The Australian Experience" 3 Cant. L. Rev 254,265

This recognition that insider trading does not simply concern transactions based on factual information but can be based on hints or suggestions conferring advantage is broad minded and pragmatic.

6 *Pragmatism: latitude for a defence?*

In his Solicitors opinion prepared in the *Wilson Neill* case Young recognized that in certain situations a strict standard of proof might not be commercially realistic and that in practice the Courts were unlikely to impose liability in the absence of fault.[52] On this basis Young suggested that it was open to the Courts to imply an "absence of fault" defence under the statute. A defendant who was proven to have possessed inside information at the relevant time could raise an absence of fault defence by showing that he or she had conscientiously considered the matter at the time of the transaction and had reached a reasonably based view that their knowledge did not amount to inside information.[53] The Court of Appeal held however that a defence of total absence of fault has no bearing on liability under section 7 or section 9 of the Act. The Court held that the only defenses available to alleged insiders are those provided in the Securities Amendment Act 1988.

It is suggested that there may be instances where elements of absence of fault can enter into conduct which constitutes insider trading. By way of example, although most buying and selling is done voluntarily, there are instances where a disposition of securities may be by Court order or other quasi-judicial body under the Commerce Act 1986, Part II of the Securities Amendment Act 1988 or possibly the Takeovers Act 1993. Also it is possible that a put option may be granted at a time when a person is not an insider but the counterparty chooses to exercise that option at a time when the

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[52]Above n11, 646 (Opinion of W G G A Young QC, Provided Pursuant to Section 17 Securities Amendment Act 1988 as to Allegations of Insider Trading in Wilson Neill Shares June 1990-September 1991 par.2.18)

[53]Above n 52[5]

person is an insider.[54] It is suggested that in any case where there is an element of involuntariness or absence of fault it may be appropriate for the Court to dismiss an action on the basis of a no fault defence.

US case law has developed in a pragmatic way in this regard. The decision of most interest is *Dirks v S.EC.*[55] Raymond Dirks, a securities analyst became aware of widespread fraud at Equity Funding Corporation of America. His sources were former and current employees of the Company. Dirks relayed his information to Equity Funding's present and former auditors and to the Wall Street Journal. The Journal contacted the SEC who investigated. The fraudulent scheme collapsed shortly thereafter. In the course of the investigation it was discovered that Dirks had relayed his information to certain institutional investors, many of whom sold their stock in the Company. The SEC brought an action against Dirks commenting that:

> "It is well established that corporate insiders who trade on the basis of material, non-public information...violate...Rule 10b-5.."Tippees" of corporate insiders, who themselves trade are equally liable. Moreover, both corporate insiders and their tippees are liable for the trading violations of those whom they in turn tip. Even where the tipper does not himself engage in trading, he aids and abets the violation by providing the means by which the wrongful act occurs."[56]

The Commission cited authority that tippees of corporate insiders might be liable as participants after the fact in the insider's breach of fiduciary duty.[57] At the Lower Court level the judge held that:[58]

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[54]Above n46,
[55]445 U.S. at 230 n 12
[56][1981] Fed. Sec L Rep (CCH) 82,812
[57]445 US at 230 n12
[58]681 F.2d at 839

> "...the obligation of corporate fiduciaries pass to all those whom they disclose their information before it has been disseminated to the public at large. Thus Dirks...became subject to his informants' disclose or refrain obligation."

This opinion effectively endorsed the SEC position that the tippee "steps into the shoes" of the insider/tipper and assumes the latter's fiduciary obligations. The Supreme Court however held that the illegal tipping and tippee trading occurs only when the selective disclosure is deemed to be 'improper'; where for example the insider tips a friend or expects to receive a pecuniary gain from the selective disclosure.[59] On this basis Dirks therefore was not liable for tipping. In taking this line the Court took a pragmatic approach to tipping liability.

The Australian cases also limit liability by provide a defence where the counterparty is aware of the nondisclosure. In light of the pragmatic development of case law as seen in other jurisdictions, the New Zealand courts should consider proposition like the no fault defence if such proposals allow for a commercially realistic and sensible development of the regulatory framework. An example where a defence might be considered appropriate for the sake of commercial reality is found in the common due diligence procedures.

7 *The problem with due diligence*

The due diligence exercise can raise significant insider trading implications. Take the following example. Company *A* is a New Zealand company whose shares are listed on the Stock Exchange. 65 % of *A* is owned by Seller Limited which enters into an arrangement to sell the shareholding to Buyer Limited. After some negotiations Buyer agrees to buy the shares on the condition that it be allowed to conduct a due diligence exercise. Usually such an exercise will mean

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[59] 464 US 646 (1983)

a complete examination of the books of the company and a review of the company's major contracts and commitments.

It is not unusual that in the course of due diligence Buyer receives profit forecasts which have not been publicly released. In the example above, Buyer was given access to half year results which had not been publicly released. In providing information under a due diligence exercise, the directors as insiders are providing information which is price sensitive to Buyer knowing that Buyer is likely to buy securities in the Company. The directors are clearly caught under section 9(1)(b)(i) of the Act.

Furthermore it is not usual that Buyer's auditors conduct due diligence examination on behalf of Buyer. The company directors would in confidence be providing the auditor with inside information. The auditor by reason of having received the information in confidence from officers of the company becomes an insider: section 3(1)(c) of the Act. The Auditors role is then to provide the information to Buyer. In providing the information to Buyer in this way the auditor is also clearly caught by the provisions in section 9 of the Act.[60]

A disgruntled shareholder may consider bringing an action against the exposed directors and/or auditor. Section 8(2) of the Act only provides a defence where the purchase of securities results from a take-over offer made by the insider in accordance with section 4 of the Companies Amendment Act 1963. Arguably there should be a defence available in other respect of block acquisitions given that the directors were acting bona fide in what they believed to be the best interests of the company. The Auditor could argue that the information was not given in confidence because it was always intended that they would pass the information on. Obviously there are

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[60]It is arguably that steps could be taken to minimise exposure. ie prompt disclosure of price sensitive information, limiting the scope of the exercise. In any event Public issuers, directors and advisers of public issuers should beware that due diligence exercises may lead to liability under the Act.

difficulties with these arguments however in the interests of market efficiency maybe the no fault defence should be available.'[61]

D Finite Links: Limited Liability

1 New Zealand: Three tiers of liability

There are only a finite number of links in the chain of liability in the present New Zealand framework. Because of this a number of cases would fall outside the ambit of the legislation. Consider for example the following hypothetical. Party *A* an insider passes inside information in confidence to Party *B* believing that B will buy or encourage another to buy securities. *B* does indeed encourage *C* to buy. *C* buys. In this example, *A* [62], *B* [63] and *C* [64] are insiders. If the information in fact passed from *C* onto *D* however, the parties would cease to be liable because of the limited tiers of liability in section 9 of the Act. Furthermore, no liability would attach to party *D* because of the limited three tier liability in the definition of insiders.

2 The US: special relationship test

Our limited framework for liability can be contrasted with the US position and the development of the "special relationship" test. In the 1980 decision of *Chiarella v United States*[65] the Supreme Court

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[61] There is one view that directors ought not to disclose any information in these circumstances as the purchaser should not be able to access non-public information simply because of the block acquisition. In support of this view the listing requirements 8.1.1(d) requires disclosure of Relevant Information at the time it is given to another person who is likely to use it in deciding whether or not to purchase shares. It has been suggested that the thrust of recent legislation in this area is to put all relevant information in the market place. If deals are being done based on non-public information perhaps the level of disclosure is too low? (see P Ratner and C Quinn, "Insider Trading", New Zealand Law Society Seminar, March 1990, p18.)

[62] section 9(1)(b)(ii)

[63] Section 9(a)(i)

[64] section 7(1)(a)

[65] 455 U.S. 222 (1980)

addressed the application of section 10(b) and rule 10b-5.[66] Vincent Chiarella worked for the financial printing firm of Pandick Press. Among the documents he handled were five announcements of takeover offers. Without disclosing his knowledge, Chiarella purchased stocks in the targets and sold the shares at a profit after announcement of the tender offers. The U.S. attorney prosecuted Chiarella for an intentional violation of rule 10b-5 and section 10(b) of the Securities Exchange Act 1934. The Supreme Court held that the disclose or abstain rule applied only when there was a pre-existing fiduciary relationship with the investors.[67] This relationship exists by virtue of the trader's fiduciary status in the public issuer. The Court held that:

> "anyone- corporate insider or not - who regularly receives material nonpublic information may not use that information to trade in securities without incurring an affirmative duty ot disclose."[68]

The Supreme Court reversed the lower court's conviction of Chiarella on the grounds that he had no relationship of trust and confidence with those from whom he bought.[69] The fiduciary relationship was with Pandick Press the employer and not the bidder corporation and therefore Chiarella was under no obligation to disclose.[70] The

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66 Under Rule 10b-5 it is considered a fraudulent practice for an insider to trade on the basis of material inside information not known to the market. Rule 10b-5 applies to an insider who has a duty of confidentiality of a fiduciary or contractual nature with regard to a company and its shareholders, such as members of the board of directors, employees, lawyers and accountants. Similarly, Rule 10b-5 applies to those who receive information from an insider (tippees), though only if the insider has breached the duty of confidentiality to the company or its shareholders and if the tippee was or should have been aware of the breach.

67 a tippee inherits the fiduciary duty of the tipper and will only be liable for insider trading if the tipper has breached a duty not to disclose information and the tippee knows or should have known of the breach (*Dirks v SEC* 463 US 646 (1983))

68 588 F 2d 1358, 1365 (2d Cir 1978)

69 445 U.S. at 230-1

70 The result reached by the Supreme Court in *Chiarella* was unsatisfactory in that many individuals have relationships which result in their possession of inside information without the requisite fiduciary connection to the owner of the information. The Misappropriation theory developed to address this

Chiarella decision essentially imposes liability on any party at any point in the chain of liability where there has been a breach of a "special relationship". The test of whether there is a breach of a "special relationship" is whether the insider or tipper gains from the tipping activity. The distinctive feature of the "special relationship" theory is its expansive application particularly in relation to tipping activity as discussed in the following.

3 Applying the "Special Relationship" test to tipping activity

Take the example of Party A who is an insider of Public Issuer X. Party A is in possession of material confidential information. Party A (the tipper) tips Party B (the tippee). The tippee then trades on the basis of the tip. The tipper naturally has a special relationship with the public issuer. Arguably the tipper also has a special relationship and owes a fiduciary duty to both existing shareholders and those who will subsequently become shareholders. Furthermore, although the tippee has no relationship of trust with the party on the other side of the transaction, once the liability of the tipper is established *Chiarella* suggests that the tippee could conceivably be held liable as a participant after the fact in the insider's breach of fiduciary duty by tipping.[71] Essentially therefore although the tippee has no direct relationship with the counterparty to the transaction the tippee assumes the tippers special relationship with the counterparty by virtue of simply having received the information from the tipper.

In this way the "special relationship" theory can be contorted to fit even the most complex tipping scenario. Consider the situation where

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situation. The theory is consistent with the proposition that insider trading and tipping is harmful because it results in the misuse of confidential information belonging to another party. The misappropriation theory states that rule 10b-5 is violated where there is a trading on material non public information in breach of a duty to the information source.

[71] 445 U.S. at 230

an insider *A* tips an outside party *B* who does not trade on the basis of the tip but in fact tips another party *C*. Party *C* then sells shares to someone who previously owned no shares in Public Issuer *X*. By tipping, the tipper is in breach of the fiduciary duty owed to the person who bought the shares from *C* in that the fiduciary duty is owed to present and future shareholders of *X*. Furthermore, the tippees *B* and *C* are liable as participants after the fact in the tippers violation.[72] It has been suggested that a simpler way of analysing the situation is to see the tippees as simply "stepping into the shoes" of the insider/tipper and assuming the insider/tipper's fiduciary relationship with the shareholders present and future.[73] The US framework is based on the need to ensure the protection of another's information and because of this the US framework for liability clearly extends beyond the New Zealand regime.

E Problematic Enforcement issues

1 Shareholder responsibility

The onus of enforcement is on the public issuer or the aggrieved shareholder. Often the initiative for enforcement falls solely on the aggrieved shareholder as the public issuer through its directors are loathe to instigate action against fellow directors or other company officers. This is in contrast with the US system where the SEC operates a strong centralised enforcement agency.[74] In New

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[72]KS Wang "Recent Developments in the Federal Law Regulating Stock Market Inside Trading" 66

[73]Above n 71

[74]It has been noted that private litigation has not been a necessary or even an effective weapon in the detection or deterrence of insider trading in America. This is partially due to the ability of government actions to obtain ancillary relief that provides private remedies within the government prosecutions. Occasionally the publicity surrounding government prosecutions stimulate collateral private actions. These suits have been described as parasitic because they not only free ride on the government's evidence, but more frequently seek to share in any profits the government's successful prosecution has wrested from the defendant. American federal securities law also relies on the class action and contingency fee devices. This not only allows large numbers of small claims to be joined together to make the suit economically advised, but the contingency fee devise overcomes the natural risk aversion of such small

Zealand's de-centralised system aggrieved shareholders themselves bring enforcement actions. The problem is that often the aggrieved shareholders do not have the financial muscle to see through lengthy and complex proceedings nor is there sufficient access to information to successfully support proceedings. The New Zealand framework has attempted to redress these problems by sections 17 and 18 of the Act.

2 *Section 17*

Section 17 of the Act provides an opportunity for shareholders who believe insider trading has occurred to apply to the Securities Commission for approval to obtain from a lawyer an opinion as to whether or not the public issuer has a cause of action against suspected insiders. In the *Wilson Neill* case an application was made by shareholders pursuant to section 17 of the Act. Although the application was successful the procedural delays in obtaining the final opinion produced by Dr Young highlights the inefficiencies of the present framework.

Gaynor, an aggrieved shareholder first wrote to the Securities Commission on 1 August 1991 requesting that an opinion be produced pursuant to section 17 of the Act. After some delays the Securities Commission advised Gaynor that contrary to its earlier advice, the Commission did not propose at that stage to approve a barrister or solicitor for the purposes of section 17 of the Act.

On 9 October 1991, another application under section 17 of the Act was made to the Securities Commission. This time the applicants comprised not only of Gaynor, but also other institutional investors involved in the alleged insider trading. This time, the Securities Commission agreed to appoint a Barrister for the purposes of securing a section 17 opinion. Arguably, the change in the Commission's

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investors. In combination they provide a vehicle for the private prosecution of securities law violations. (see further R Tomasic, "Corporations Law Enforcement Strategies in Australia", 1990 Sydney Law Review, Vol 12, p 192.)

position was the result of the additional pressure of the institutional applicants. Where one shareholder's request was denied, a collective request from several investors including institutional investors was successful. It is suggested that this highlights the difficulty with proceeding under the Act as a single aggrieved shareholder without the support of collective pressure from other aggrieved shareholders.

3 Other available avenues ?

Another option said to be available to aggrieved shareholders is an action against current and former directors for breach of their fiduciary duty to the company. This option would be exercised under Part VIII ss 131-138 Companies Act 1993.[75] It should be remembered however that the shareholders of the target Company would have to bring an action. The shareholders would have to prove that the company suffered damage. The difficulty arises at this point, what damage did the company suffer?

F Time for a More Proactive Approach

1 The role of the Securities Commission

It has been suggested that one of the most disappointing aspects of the enforcement framework is the lack of support from the Securities Commission to aggrieved shareholders.[76] As one aggrieved shareholder in the *Wilson Neill* case has noted:[77]

> "Not once during the four years did the Commission contact me to keep me informed about developments. I had to constantly phone or write to the Commission to seek information and this information was often reluctantly given."

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[75]It has been suggested that Director's liability insurance would cover any actions. It should be noted however that it is likely that the insurance policies would exclude liability for actions in the case of tipper activity

[76]Above n31, 65

[77]Above n31, 65

In the absence of a centralised enforcement regime in New Zealand, the Securities Commission must surely take a more central role in overseeing the mechanics of the legislative framework. Although the statutory authority for taking a more proactive role is somewhat deficient, the policy reasons [78] behind the legislative framework must still encourage and demand the Securities Commission take a more active role in enforcement.

A recent report[79] suggests that the framework be widened to allow the Securities Commission standing to apply to the Court for orders in relation to insider trading. The report notes that:[80]

> "[there is] often understandable reluctance of public issuers to instigate proceedings for insider trading where the cost 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."

In light of the *Wilson Neill* case there is no doubt that the effectiveness of the enforcement provisions would benefit from the Securities Commission playing a more proactive role. Arguably it is the cost factor that has resulted in the Commission taking a less active

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[78] In 1980 the New Zealand Securities Commission stated the policy basis for securities regulation in New Zealand as follows:
(1) The objects of commercial law are to aid the transaction of business by honest and fair means.
(2) The law should ensure that the public is informed fairly and in good time, both of the terms of the offer and of the information relevant to making decisions about it.
(3) The law should attach responsibility and liability for dishonest and unfair conduct where they fairly belong.
(4) The remedies should be simple, direct, effective and as inexpensive as possible.
(5) There should be equality before the law (see *Proposals for the Enactment of Regulations Under the Securities Act 1978* (1980))

[79] Securities Commission discussion paper "Review of the Law on Insider Trading", 11 August 1994,5

[80] Securities Commission discussion paper "Review of the Law on Insider Trading", 11 August 1994, 5

role to date in enforcement proceedings. It has been suggested that[81]:

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

2 Enforcement powers in the United States

It has been noted that the enforcement of insider trading is so centralised in the United States is a natural effect of the offence.[82] Insider trading is an offence of stealth whose presence initially can only be detected inferentially.[83] The SEC's enforcement efforts are heavily dependent on the electronic market surveillance systems used by regulatory organisations.[84] The organisations first monitor trading activity through computer systems that identify abnormal price or volume changes within seconds of their occurrence.

Once an unusual activity is detected a review of wire releases determines whether the activity can be explained by industry or company specific information.[85] If the activity cannot be explained the specific company is contacted to determine if there is an unannounced corporate event. If the activity is identified as suspect, the brokerage firm executing the transactions is identified and through the company a profile of the trading customers is prepared.[86] This information through a search database ASAM to identify the trader's relationship if any to the company. The ASAM

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[81] Securities Commission discussion paper "Review of the Law on Insider Trading", 11 August 1994, 6

[82] Above n11,627

[83] Above n11,627

[84] Above n11,627

[85] Above n11,627

[86] Above n11,627

database holds general information in relation to 500,000 corporate officers, directors, attorneys, accountants, and other individuals having corporate contact.[87] Once the investigators believe that there is sufficient evidence to support insider trading, the evidence is forwarded to the government prosecutors.[88]

In 1984 the SEC has had the authority under the Insider Trading Sanctions Act to seek civil penalties up to triple the insider-trading profits against insider traders.[89] This provision has been subsequently amended to enable the SEC to apply this sanction to brokerage houses, investment advisory firms and other organisations who fail to take adequate steps to prevent insider trading by their employees.[90] By expanding sanctions in this way to employers the system effectively increases incentives for employers to vigorously supervise their employees.

It is clear that the New Zealand enforcement process is some way behind the US system described above. New Zealand also lags behind Australia which has a surveillance of market activity (SOMA) software system which was introduced by the Australian Stock Exchange (ASX) in 1989.[91] Arguably if the Securities Commission is give the power to effectively police the enforcement framework, the de-centralised system we presently are confined to will have to take on a more centralised nature. If indeed we are moving in this direction consideration will need to be given to a system in which the Commission can actively and efficiently operate.[92]

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[87]Above n11,627

[88]In 1988 the US Congress augmented available detection procedures by providing a bounty award of up to 10% of the government recovery for those who assist the government's detection of insider trading: The Insider Trading and Securities Fraud Enforcement Act 1988, amended s.21A(e) Securities Exchange Act 15 USC 78 to provide for this award.

[89]US Securities Exchange Act, s.21(d)(2)(A)

[90] Above n11, 629

[91]Above n11,698

[92]Consideration will need to be given to the enforcement powers that the Securities Commission will require. Arguably the single most important power would be the power to obtain information from anyone. Once a matter is identified as appropriate for investigation, there should be no impediment,

3. *Call for a more proactive approach to the problem of insider trading*

There are significant difficulties with the present regulatory framework in New Zealand. The first difficulty lies in the detection of the offence of insider trading. There is no electronic surveillance system in place that can monitor insider trading activity on which to base prosecutions. It is suggested that in the absence of systems found in the United States or even Australia, the must be legislative reform to provide incentives for people to report insider traders. In the US the obligations on employers and organisations to monitor trading activity is an example of the type of incentives that may need consideration. Also the provision for a bounty or award to be paid to informers may require consideration.

There are inherent difficulty in proving the elements of the offence successfully. As discussed above, the evidential difficulties are impenetrable in some instances where the plaintiff is required to prove that the insider received the information in confidence. Perhaps the legislation should provide the Court with the ability to infer that the information was passed in confidence by the facts of the case particularly in light of the fact that:

> insider trading cases...are proven by creating a mosaic of circumstantial evidence which, when considered as a whole, lead to the inference that the insider possessed inside information or a tipper communicated non-public information. For example, an unusual trading pattern alone probably would not be enough from which to draw the necessary inferences for insider trading liability, but if that evidence were coupled with the opportunity to receive non-public information, the totality of the circumstantial

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save for privileged communications and the right against self-incrimination, that fetters the ability to get the evidence it seeks. The position must be achieved whereby market investors are assured that once detected, the enforcement entity has tools to identify and gather the necessary evidence to prosecute wrongdoers.

> evidence would be sufficient to support the inference that the trader possessed non-public information at the time of the transaction.[93]

Similarly a reversal of the onus of proof could be considered to require the insider to establish that the insider did not pass the information in confidence. This reversal of the onus of proof may be justifiable on the basis that the insider and tipper arguably knows the context of the situation better than the plaintiff.

The second area of difficulty concerns the need to encourage the law to develop pragmatically to cater for the commercial realities and characteristics that surround inside trading activity. In the final analysis, a regulatory approach that stifles market efficiencies is unwelcome.

The last problem area relates to enforcement of the regulatory framework. It is suggested that the detection, investigation and prosecution of insiders should be the New Zealand Securities Commission first priority. If a central system of enforcement is not desirable or likely[94] penalties that have a significant deterrent effect may need to be considered. For example section 16(b) of the Securities Exchange Act 1934 (US) provides that, regardless of whether or not the person possesses inside information, all profits made by officers, directors, and shareholders beneficially owning more than 10 % of the company's shares in dealings involving the company's shares, will belong to the company if the sale and purchase of shares occurs within six months. One commenator has stated that[95]:

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[93] Above n11,700

[94] The 1994 Annual Report of the Securities Commission states that : "Broadly speaking our aim will be, consistent with the policy of the Act, to strengthen procedures available for shareholder enforcement. We will not propose an increase in the role of the Commission or other centrally funded enforcement agency."

[95] Beerworth, Insider Trading - Current Issues (1989) Butterworths Company Law Bulletin [187]

> Section 16 has been working away like a bilge pump for fifty-five years. The beauty of the system is that it removes any moral taint and eliminates any questions of motive and the need to define what is inside information.

It is suggested that the enactment of a similar provision in New Zealand should be considered as providing a significant deterrent effect given the weakness of surveillance of the securities market.

V CONCLUSION

The US experience is an illustration of a regulatory system that has developed pragmatically to accommodate socially desirable flows of information. It is suggested that the problem with insider trading is its misuse of information. Care must be taken in New Zealand to ensure that the Courts have an opportunity to guide the New Zealand proscription of inside trading in an efficient and workable manner.

The greatest problem with the present framework however centres on enforcement efforts. Current sanctions available to the Securities Commission are too modest and do not invoke a sufficiently proactive stance from the Commission. Private actions by aggrieved investors are hamstrung by the issues of proof and high level of costs involved. The *Wilson Neill* is a true example of the excessive delays and inordinate efforts required to achieve a result that in the end may not be worth it. To be fair the *Wilson Neill* case was a test case and some of the procedural problems may have been addressed and overcome. It is suggested however that this may not be enough.

In the final analysis the problem of insider trading should be recognized as a national problem. Arguably the only cost of deterring insider trading by vesting a centralised entity with enforcement

powers to recover more than the defendant's illicit gains and the cost of empowering the courts to provide ancillary relief where appropriate to compensate those proximately harmed by the insider's misconduct must be paid.

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