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THE SHORTFALL IN FINANCIAL MARKETS REGULATION: WHY NEW ZEALAND SHOULD REVISIT ITS INSIDER TRADING LAWS

A comparative analysis of current insider trading legislation and enforcement mechanisms in New Zealand, the United States and the European Union

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Abstract

Insider trading is an exceptionally challenging offence to define, prove, and enforce. New Zealand is a country especially vulnerable to this challenge, with no insider trading convictions since first regulating the offence in 1988. This paper investigates the reasons behind this, by comparing the structure of New Zealand's legislation and enforcement to the United States and the European Union. A reform of the Financial Markets Conduct Act is suggested, with four main areas identified to enhance the strictness of New Zealand's legislation. A novel approach to enforcement is also recommended, through the introduction of a rewards scheme for whistle-blowers to reduce the inherent difficulty of meeting the criminal standard of proof.

Key words: *"insider trading", "financial markets", "Financial Markets Conduct Act 2013", "whistle-blowing"*

I Introduction

Well functioning financial markets with a high level of regulatory development lead to high levels of economic growth.[1] Growth in the size and depth of New Zealand's financial markets is a primary objective of the New Zealand Government, as they remain "small and underdeveloped by international standards".[2] With increasingly more companies raising capital across national borders, and investors frequently depositing money in other countries, the traditional separation between domestic and international financial markets has been eroded. As a result, jurisdictions are accordingly committed to developing sound regulatory and enforcement mechanisms in order to ensure effective protection of both local and foreign investors.

Insider trading presents a major risk to the transparent and fair operation of financial markets. This paper explores the interface between law and finance, specifically the impact of insider trading regulation on the functioning of financial markets. Broadly speaking, insider trading is the practice of buying or selling shares on an exchange to one's own advantage by having access to material and non-public information. The concept further encompasses the disclosure of material non-public information to non-insiders, and

[1] Lauren Rosborough, Geordie Reid, and Chris Hunt "A primer on New Zealand's capital markets" *Reserve Bank of New Zealand Bulletin* (online ed, Wellington, May 2015) at 6; Jeffrey Wurgler "Financial markets and the allocation of capital" (2000) 58 Journal of Financial Economics 187; Luc Laeven *The Development of Local Capital Markets: Rationale and Challenges* (International Monetary Fund, Working Paper 14/234, 19 December 2014).

[2] Ministry of Business, Innovation and Employment *The Business Growth Agenda: Towards 2025* (September 2015). See also Rosborough, Reid and Hunt, above n 1, at 20.

encouragement for non-insiders to trade based on the non-public material information the insider trader holds. With more than USD 1.7 trillion worth of shares traded on financial markets globally each day,[3] there is a substantial likelihood that traders execute some of these whilst in possession of material non-public information. This is problematic as it effectively allows a select few to significantly profit or avoid losses at the complete ignorance of general investors.

Many believe insider trading should be an “eminently deterrable crime”.[4] As a category of white-collar crime, insider trading is labelled as the ‘easiest crime in the world to commit’ with traders able to make a great deal of money by committing it. Some commentators disagree entirely, stating that insider trading results in financial markets operating more efficiently. Therefore, the central question this paper asks is whether regulation is necessary for insider trading, whilst an attempt is made to elucidate the ideal legislative structure and enforcement mechanism.

Despite insider trading being a serious issue facing financial markets globally, the vigour with which insider trading regulation is structured and enforced varies greatly. In New Zealand, the past 30 years have seen frequent legal changes and low enforcement levels, resulting in no successful insider trading convictions. Anecdotal evidence and common sense suggests that insider trading is almost certainly happening on the NZX. It is unlikely that traders in New Zealand are significantly more honest than those overseas, where hundreds of successful insider trading convictions have been made in recent years.[5] Therefore, this paper seeks to understand why New Zealand has such a poor prosecution record, by undertaking a comparative analysis of the legislation and enforcement mechanisms in the United States and the European Union.

[3] This figure was calculated by using the average daily volume traded of the twenty largest share exchanges worldwide based on market capitalisation as at 31 January 2016. I then used the 80/20 rule, assuming that the top twenty exchanges contribute to eighty per cent of the total amount traded worldwide to reach USD 1.73 trillion. Note: this is the total monetary amount traded, not the actual number of shares traded e.g. one trade could be $500 in value for 20 shares.

[4] Interview with Preet Bharara, United States Attorney for the Southern District of New York (Massimo Calabresi, TIME, 24 January 2012) edited version of transcript provided by TIME (online).

[5] See, for example, United States statistics at “SEC Enforcement Actions – Insider Trading Cases” (28 April 2015) United States Securities and Exchange Commission <www.sec.gov>. For Australian statistics see Australian Securities and Investments Commission *ASIC supervision of markets and participants: July to December 2014* (Report 425, March 2015).

This paper argues that New Zealand's legislation falls short on its definition of material information and disclosure of inside information, whilst its civil sanctions are too lenient compared to overseas counterparts. However, the most prominent issue identified is the enforcement approach New Zealand takes to insider trading. To that end, this paper suggests New Zealand implements a rewards scheme for whistle-blowers who come forward with insider trading information, amongst other suggestions. By a careful and consistent adoption of this system, the burden of proof issue that hinders conviction can be addressed, and potentially assist in further deterring insiders from trading.

The paper has five substantive parts. Part II introduces the concept of insider dealing and emphasises the importance of effective regulation from an academic perspective. Part III discusses the varying rationales for regulating insider trading against views supporting no regulation. This introduces the competing policy choices that lead to different legislative foundations in each jurisdiction, whilst highlighting the analytical strengths and weaknesses of each rationale. Part IV discusses the inconsistent legislative history of New Zealand in order to emphasise the uncertain and difficult nature of structuring insider trading regulation. Part V uses a hypothetical case study to undertake a comparative analysis of insider trading legislation. From this, it will be seen that different legal consequences and policy issues arise from the same facts, and the paper identifies the most effective structure for each element of the offence. Finally, Part VI examines the sanctions and enforcement mechanisms in each jurisdiction in relation to their deterrence efficacy, and discusses modifications to New Zealand's current enforcement approach, before settling on a rewards scheme for whistle-blowers.

II Background

Despite many recent high profile prosecutions globally, the meaning of insider trading remains elusive. The exact definition of insider trading is dependent on the legal jurisdiction in which the conduct occurs. However, in a general sense insider trading is the buying or selling of a security whilst in possession of material non-public information about that security.[6] In New Zealand, insider trading is illegal under the Financial Markets Conduct Act 2013 (FMCA). The Act states an "information insider" is a person possessing material, non-public information regarding a listed company, who knows or ought reasonably to know that the information is material and non-public.[7] The Act prohibits

[6] The concepts of "material" and "non-public" information are the two core concepts underpinning global insider trading legislation, with courts and regulatory bodies grappling as to the exact meaning and boundaries of these concepts. Part V of this paper contains an analysis of the law behind both of these definitions.

[7] Financial Markets Conduct Act, s 234.

information insiders from trading securities of the listed company,[8] disclosing the inside information to another person,[9] or advising another person to trade or hold securities of the listed company.[10]

A Importance of effective regulation of financial markets

Insider trading requires effective regulation as it presents a serious risk to the fair and transparent functioning of financial markets. In a general sense, insider trading is objectionable as it puts the public investor at a disadvantage, allowing some traders to obtain virtually guaranteed profits or to avoid an inevitable loss. This realisation by non-insider investors can in turn lead to withdrawals of liquidity from financial markets, which adversely affects the overall economy. This section briefly explores the interaction between finance and the law, in an attempt to justify the importance of effective insider trading regulation for the prosperous performance of financial markets.

La Porta and others, professors at Harvard University, transformed the study of finance and comparative law in their discussion on how the legal rights of equity holders are enforced, in both common law and civil law countries.[11] Their papers are regarded as some of the most important and well-respected papers in the field of financial law, so the findings are given considerable weight in this paper.[12] Their findings demonstrate that common law legal origin is positively related to the level of investor protection in a country and to the country's degree of financial development and corporate valuation.[13] Conversely, civil law legal origin is negatively related to investor protection, financial development, and corporate valuation. These studies imply that you would expect New Zealand to afford financial market investors a high level of protection given other common law countries do. As will be elucidated further in parts V and VI, this paper concludes this is not the case.

In a second area of research, La Porta and others found that more stringent legislation leads to a significantly greater frequency of insider trading law enforcement, which results in

[8] Section 241.

[9] Section 242.

[10] Section 243.

[11] La Porta and others "Law and finance" (1998) 106 Journal of Political Economy 1113. This paper is one of the most cited papers in social science.

[12] Steve Kaplan and Luigi Zingales "How 'Law and Finance' transformed scholarship, debate" (5 March 2014) Chicago Booth Review <www.review.chicagobooth.edu>.

[13] La Porta and others, above n 11; La Porta and others "Legal determinants of external finance" (1997) 52 The Journal of Finance 1131; La Porta and others "Investor protection and corporate governance" (2000) 58 Journal of Financial Economics 3.

appreciably more liquid financial markets.[14] This is supported by further consensus among academics that the mere presence of insider trading regulation may appear sufficient, however the presence of such regulation does not protect investors if the legislation is unsound or unenforceable, or if regulators lack the will and resources to enforce them.[15] Research also indicates "[c]ountries with more prohibitive and strict insider trading laws have…more accurate share prices, and more liquid share markets.[16] Stricter insider trading laws are also found to result in reduced ownership concentration and improved price accuracy,[17] more effective controlling of insider trading profitability,[18] and a reduced level of private information trading.[19] Again, sections V and VI of this paper conclude New Zealand's insider trading regulation is not as strict as it could be.

These two findings provide justification for law reform in New Zealand, as if it sits behind its international common law counterparts in the sphere of investor protection; there is a risk investors will shift their capital offshore, impacting negatively on New Zealand companies, and the economy in general.[20] This justification is further supported by the fact New Zealand has had no successful insider trading convictions, reinforcing the conclusion of this paper that the legislation is non-stringent, and thus non-effective. A further key theme of La Porta and others in support of a law reform in New Zealand is the finding that government intervention is vital in reducing the prevalence and problems associated with insider trading.[21] Absent effectively enforced rights by the government, insiders would not have much of a reason to repay the creditors or to distribute profits to shareholders, and external financing mechanisms would tend to break down.[22]

[14] As measured by La Porta and others "Legal determinants of external finance", above n 13.

[15] See, for example, Jeffrey Jaffe "The Effect of Regulation Changes on Insider Trading" (1974) 5 Bell Journal of Economics and Management Sciences 93. See also Nejat Seyhun "The Effectiveness of Insider-Trading Sanctions" (1992) 35 Journal of Law and Economics 149. See also Bhattacharya and Daouk "The World Price of Insider Trading" (2002) 57 Journal of Finance 75.

[16] Laura Nyantung Beny "Does Insider Trading Law Matter? Some Preliminary Comparative Evidence," (2005) 7 AM L & Econ Rev 144, at 146.

[17] At 148.

[18] A Bris "Do Insider Trading Laws Work?" (2005) 11 European Financial Management Journal 267.

[19] Durnev and Nain "Does Insider Trading Regulation Deter Private Information? International Evidence" (2007) 15 Pacific Basin Finance Journal 489.

[20] Frijins and others "Do criminal sanctions deter insider trading?" (2013) 48 The Financial Review 205, at 6; Seyhun, above n 15; La Porta and others "What Works in Securities Laws?" (2006) 61 Journal of Finance 1.

[21] La Porta and others "Investor protection and corporate governance", above n 13, at 14.

[22] La Porta and others "Investor protection and corporate governance", above n 13, at 7.

This section concludes that regulation must be effective, rather than simply existing. As held by Bhattacharya, for insider trading laws to be effective, they must be enforceable, and if they are not in fact enforced, research suggests the country may be better off with no insider trading regulation at all.[23] In summary, this paper categorises effective insider trading regulation as involving the satisfaction of two elements: clear and administrable legislation of an appropriately strict scope, and reliable deterrence through robust enforcement. This paper uses these two elements to structure an investigation into New Zealand's current unsuccessful regime; scope of legislation is discussed in part V, with deterrence and enforcement situated in part VI.

III Impetus for insider trading regulation

The debate surrounding the effectiveness of insider trading regulation continues to receive a great deal of attention from academics, lawyers and economists, resulting in prolific literature on the matter. The debate has settled on four distinct rationales that support the above justification of the importance of effective regulation. This paper does not attempt to canvass every argument, the discussion is limited to the identification of the main features of the debate in order to contextualise New Zealand's approach to insider trading in comparison to the United States and the European Union. Countries are faced with a "smorgasbord of theoretical explanations for action or inaction, some compatible with each other, others not".[24] Each country tends to base its regulation on one or two of the different rationales explained below.

A Fiduciary duty

United States courts have been the primary source of development of the fiduciary duty rationale for insider trading.[25] Crucially, the existence of an interpersonal relationship between the insider and the company is required. The rationale stems from the premise that insiders of listed companies can access confidential and significant information that if made public, would alter the company's share price. It maintains that these insiders have a fiduciary duty to serve the interests of the company and its shareholders. A person who owes these fiduciary duties to a company should not trade securities of that company to

[23] See generally Bhattacharya and Daouk "When no law is better than a good law" (2009) 13 Oxford Review of Finance 577.

[24] Jane Diplock and Louise Longdin "The Journey Towards Effective Insider Trading Regulation in New Zealand" (2007) 13 NZBLQ 290 at 293.

[25] New Zealand's insider trading regime was previously based on a variation of this rationale, namely breach of confidence. See part IV for a discussion on the history of New Zealand regulation.

make a profit or avoid a loss using the company's non-public material information.[26] The use of such information to formulate a decision to trade securities creates an unfair advantage to shareholders and public investors, as they do not have access to this information. This primary duty also encompasses the duty not to use corporate information for personal gain, the duty not to profit from a position of trust, the duty of loyalty and the duty to avoid conflicts of interest.[27] *S.S.C. & B: Lintas New Zealand v Murphy* held it is "not so much a matter that the information itself is confidential, but that the information was acquired in circumstances whereby the recipient of the information is expected to keep it confidential and not to use the information to the detriment of the person conveying the information to him".[28] The structure of the majority of the United State's current insider trading legislation reflects this rationale.

A sizeable drawback of this rationale is that the scope of this duty is limited because of the prerequisite requirement of some form of relationship with the company. This results in "outsiders" who have evidently used inside information to make a profit or avoid a loss being exempt from possible prohibition for insider trading. For example, the fiduciary duty rationale would theoretically allow an employee of a prospective bidder company to purchase the shares of a target company before public disclosure of a takeover bid. The takeover offer would indubitably be for a higher price than the current share price, consequently allowing the employee to make a guaranteed profit of the difference between the takeover offer price and the current share price. This was the exact result in a landmark United States case, *Chiarella v United States*.[29] In that case, an employee of a financial printer company was able to identify the targets of several takeovers through reading takeover bid documents.[30] He purchased shares in these companies after reading and printing these documents, before selling these shares to the bidder company who offered a substantial premium.[31] The Supreme Court held the employee was not guilty of insider trading as he had no fiduciary relationship with the company. This highlights the ineffectiveness of the narrow bounds of the fiduciary duty rationale. It allows outsiders to intentionally exploit confidential information at the expense of market participants.

[26] *Chiarella v United States* 445 United States 222 (1980) at 222.

[27] *Dirks v SEC* 463 US 646 (1983) at 14;. *Chiarella v United States*, above n26, at 222.

[28] *S.S.C & B Lintas New Zealand Limited v Murphy* [1986] 2 NZLR 436 (HC) at 393. This was confirmed by *Pacifica Shipping Co Ltd v Andersen* [1986] 2 NZLR 328 (HC).

[29] *Chiarella v United States*, above n 26.

[30] At 223.

[31] At 224.

B Misappropriation

The United States also follows the misappropriation rationale. This rationale propounds that a person entrusted with confidential information who uses it in a wrongful manner violates the duty owed to the person who provided the information or who is the information source. Under this theory, only corporate insiders or outsiders, who steal, bribe or otherwise wrongfully acquire corporate secrets can be guilty of insider trading.[32] Corporate outsiders are thus included within the definition of "insider" if they misappropriate information, then trade using this information in violation of a duty of trust or confidence owed to the source of the information.[33] Therefore, a person with no fiduciary relationship to the company can be liable for insider trading.[34] The courts have applied this theory to attorneys, accountants, consultants and others who temporarily become fiduciaries of a company.[35]

However, there is confusion surrounding the articulation of which non-fiduciary relationships contain the requisite "trust and confidence" sufficient to give rise to liability. Recent cases in the United States emphasise this inconsistency, with various cases reaching conflicting outcomes. *SEC v Yun* held it is "unsettled whether non-business relationships, such as husband and wife, provide the duty of loyalty and confidentiality necessary to satisfy the misappropriation theory".[36] In *United States v Kim*, the court held no duty of confidentiality arises between members of a social group despite the club rules accentuating confidentiality.[37] Contrariwise, *SEC v Kirch* held there was a duty of confidentiality among group members because the need was understood.[38]

C Market fairness

This rationale advances that an equal playing field should exist between all investors who engage in the trading of shares on a share exchange. It suggests that the integrity of financial markets is jeopardised where one party gains an unfair advantage when trading based on material non-public information. It provides a wider prohibition on insider trading than the

[32] John R Boatright *Foundations of Business Ethics: Ethics in Finance* (3rd ed, Wiley-Blackwell, 2014) at 185.

[33] *United States v O'Hagan* 521 US 642 (1997).

[34] *United States v Newman* 664 F 2d 12 (2d Cir 1981). In this case, Newman, a securities trader, traded based on material non-public information about corporate takeovers that he obtained from two investment bankers, who had misappropriated the information from their employers.

[35] *Dirks v SEC*, above n 27.

[36] *SEC v Yun* 327 F 3d 1263 (11th Cir 2003).

[37] *United States v Kim* 184 F Supp 2d 1006 (ND Cal 2002).

[38] *SEC v Kirch* 263 F Supp 2d 1144 (ND Ill 2003).

two aforementioned rationales. The market fairness approach represents the idea that all participants in a market should have equal access to information about a listed company,[39] with the same opportunity to obtain and evaluate information pertinent to their trading decisions.[40] Nonetheless, all share market participants remain free to spend time analysing and researching public information to gain superior expertise and reaction times than other participants. The market fairness rationale does not treat the use of public information as an information asymmetry, only the access to non-public information. To be guilty of insider trading under this rationale, only an "information connection" is required, not an actual personal connection with the company.[41] The key to the market fairness rationale is the determination of when trading based on material non-public information is unfair. The rationale applies whatever the source, although as this requirement is broad, it requires certain exceptions.[42] Legislation in both New Zealand, and the European Union, stems from the market fairness rationale.

D Market efficiency

The market efficiency rationale also plays a large part in New Zealand and the European Union's insider trading legislation. Underlying this rationale is the concept that insider trading adversely affects financial markets themselves. This rationale is based on the premise that insider trading damages these markets by harming investor confidence in the integrity of the market.[43] If investors believe that insider trading is occurring, and are aware that insiders are constantly exploiting their privileged access to information by trading ahead of the market, they will conclude that security trading is biased and realise they are missing the opportunity to maximise returns. For example, suppose investors knew company directors could tell friends and family to buy shares before announcing a dividend increase. The realisation that once the company informs the public of the dividend announcement, the share price will rise and these friends and family can sell their shares and make a definite profit, would discourage participation in this market, as investors will know they are perpetually at a disadvantage. The European Union and New Zealand also factor this rationale into their respective legislation drafting.

[39] Financial Markets Authority *Investigations and Enforcement Report* (September 2014) at 20.

[40] Ian Lee "Fairness and Insider Trading" (2002) Colum Bus L Rev 199.

[41] Trish Keeper "Insider Trading" in Victoria Stace and others *Financial Markets Conduct Regulation: A Practitioner's Guide* (LexisNexis, Wellington, 2014) at 270.

[42] Including, in New Zealand for example, the Chinese wall defence and the defence for fixed trading plans. These are unable to be discussed at length in this paper.

[43] Financial Markets Authority, above n 39, at 20.

Consequently, this knowledge reduces incentives for participation in financial markets, when it is strongly in the public interest to encourage people to invest in markets.[44] This is because investment in securities provides companies with capital for growth, along with affording individuals the opportunity to maximise their wealth. Withdrawals from financial markets leads to reduced market liquidity.[45] Reduced liquidity in turn means those willing to invest will pay less for a share due to the risk they will not be able to sell it. Lower prices in the market lead to firms cost of capital increasing through diminished access to capital,[46] and the overall efficiency of the country's economy decreasing.[47]

E Non-regulation

There are a considerable number of legal theorists and professional economists who believe insider trading should be legal. These academics argue insider trading should be allowed as it "is impossible to police and helpful to markets and investors".[48] Milton Friedman, laureate of the Nobel Memorial Prize in Economics asserted, "[You] want more insider trading, not less. You want to give the people most likely to have knowledge about deficiencies of the company an incentive to make the public aware of that".[49] This section lays out the various arguments for legalising insider trading.

1 Employee compensation

Henry Manne, Dean Emeritus of the George Mason School of Law, and founder of the law and economics discipline, argues insider trading is a legitimate form of compensation for corporate employees.[50] Allowing insider trading creates an incentive for insiders to increase innovation since they have the opportunity to benefit from the value they create. Purchasing shares in their company incentivises innovation by insiders through promising rewards for growth if this innovation leads to a rise in the share price.[51] Insiders can essentially "cash in" on their private information. Proponents of this argument claim that it leads to lower base salaries as company boards can reduce the remuneration formally

[44] Rosborough, Reid, and Hunt, above n 1, at 2; Ministry of Business, Innovation and Employment, above n 2, at 4.

[45] See generally Louis Cheng and others "The effects of insider trading on liquidity" (2006) 14 Pacific-Basin Finance Journal 467.

[46] La Porta and others "Legal Determinants of External Finance", above n 13, at 1138.

[47] Christopher Matthews "Why Is Insider Trading Even Illegal?" *TIME* (online ed, New York, 26 July 2013).

[48] Donald Boudreaux "Learning to Love Insider Trading" *The Wall Street Journal* (online ed, New York, 24 October 2009).

[49] Interview with Milton Friedman, Nobel Prize-winning Economist (Michelle Caruso-Cabrera, CNBC Power Lunch Interview, 12 March 2003).

[50] See generally Henry G Manne *Insider Trading and the Share Market* (The Free Press, Toronto, 1966).

[51] At 121.

paid to managers (salary and bonuses) as insider trading is a form of supplementary compensation. This benefits shareholders, as there will be more net profit left over for dividend distributions, for example.[52]

Although this argument is in theory correct, it fails to address the hazard of creating an incentive for insiders to enter into risky ventures on behalf of the company for short-term personal gain.[53] Moreover, if insider trading were legal companies would delay important disclosures at shareholders expense in order to capture the economic benefits of the upcoming announcements. In terms of compensation structure, there are additional and arguably more superior methods of rewarding directors than allowing them to exploit their knowledge of confidential material information. [54] These include higher salaries, bonuses and share option packages. Moreover, it is likely that not every insider would deserve the reward received from insider trading. For example, it is questionable whether low-level back function employees with no input in the decision-making or implementation of a share price changing transaction deserve the benefits obtained by insider trading.

2 Faster information transmission

Another significant area of research argues that instant and full reflection of all the relevant information of a security is a prerequisite for efficient financial markets.[55] Insider trading makes markets more efficient as there is a general increase (or decrease) of share price when insider trading is occurring, rather than an explosive jump on the announcement date.[56] Only where there is full and instant reflection of *all* relevant information (not just public information) will market prices serve as a reliable standard for the investment value of securities.[57] This in turn makes prices more accurate and enables the market to determine the correct price of securities more efficiently. When insiders cannot act on their inside

[52] At 133.

[53] Thomas Newkirk and Melissa Robertson “Speech by SEC Staff: Insider Trading—A United States Perspective” (16th International Symposium on Economic Crime, Jesus College, Cambridge, 19 September 1998).

[54] Ministry of Economic Development *Insider Trading Discussion Document* (September 2000) at 16.

[55] Manne, above n 50, at 112; Stephen Bainbridge "The Insider Trading Prohibition: A Legal and Economic Enigma" (1986) 38 U Fla L Rev 35; Bryce Wilkinson “Insider Trading Legislation: Weak Analysis and Troubling Outcomes" in Charles Ricket and Ross Granthan (eds) *Essays on Insider Trading and Securities Regulation* (Brooker’s, Wellington, 1997) at 170.

[56] See generally Alan Vogt “Book Reviews: Insider Trading and the Share Market. By Henry G. Manne. New York: The Free Press, 1966 Pp. xiii, 274” (1967) 16 Buff L Rev 520. See also Alexandre Padilla “Should the Government Regulate Insider Trading?” (2011) 22 J Libertarian Stud 379.

[57] Burton Malkiel ”Efficient market hypothesis” in Peter Newman and others (eds) *The New Palgrave Dictionary of Money and Finance* (Palgrave Macmillan, London, 1992) at 672.

information, the share market is inefficient as it does not incorporate all relevant information in each share price.[58] Conveying information to the market as quickly as possible helps to lessen information asymmetry and allows the information to reach the maximum number of participants. This in turn mitigates price volatility and lessens exposure to bad information, benefiting market participants.

With regulation against insider trading, upon the public release of information, investors often rush to react expeditiously to exploit the news, resulting in the share price moving too far in one direction. Such insider trading prohibitions prevent the market from adjusting as rapidly as possible to changes in the demand for, and supply of, shares. The result of this is "prices that lie".[59] Deregulating insider trading will result in a share price that will move more gradually to its true and accurate value.[60] Following this method, a company can use insider trading to communicate changes in fortunes to the market without disclosing confidential sensitive information.[61] This argument expands to conclude that insider trading has a positive effect on market efficiency since it speeds up the information signals to the market, which will ultimately result in information efficiency of prices.

To put this into perspective, suppose that unscrupulous management drives Company X to the edge of bankruptcy.[62] Being dishonest, its managers succeed for some time in hiding its perilous financial situation from the public. During this period, Company X's share price will be too high to reflect the true value of the company. Investors will purchase shares in Company X at prices that conceal the company's imminent tragedy. From a wider economic perspective, it is also possible that creditors will extend financing to Company X on terms that do not compensate the creditors for the true risk. Further, it is conceivable that some employees of Company X have turned down job offers to remain at what they are misled to believe is a financially stable company. Ultimately, the misled investors, creditors, employees and the economy at large will suffer financial loss. This is because capital that otherwise would have been invested in companies more efficient than Company X never reached them. This emphasises that it is in the public interest for prices to adjust as quickly as possible to economic realities by insider trading. If the executives began

[58] Jeffrey Dorfman "Make Insider Trading Legal to Stop Hurting Ordinary Investors" (22 March 2015) Forbes <www.forbes.com>.

[59] Boudreaux, above n 48.

[60] Matthews, above n 47.

[61] Ministry of Economic Development, above n 54, at 14.

[62] Example based on Bourdreaux, above n 48.

selling their shares in Company X due to its perilous outlook, the share price will gradually adjust to convey to the market as clearly as possible the true state of the financial situation.

Though this appears to be a logically sound argument, it falls short in terms of practical soundness. The level of trading undertaken by a limited number of traders is unlikely to have a significant effect on the whole market, thus will not produce effective signalling. The example shows it may be more economically efficient, but the question becomes whether the "smooth" movement in price is worth the unfair consequences to investors. This paper argues it is not. Information symmetry and the resulting confidence in markets and increased liquidity outweigh the pinpoint accuracy. Studies show that share prices adjust back to accurate reflections within one to three days post announcement,[63] which is unlikely to inconvenience the public investor.

3 Private contracts

Opponents argue that insider trading legislation is ineffective and "impossible" to police, meaning it has minimal impact on financial markets.[64] Evidence of this ineffectiveness includes low enforcement rates and very few convictions against insiders. Another consideration is the detection difficulty of insider trading activity, which adds to low conviction rates.[65] These advocates suggest private contracts between companies and insiders be used instead of legislation.[66] The argument is that private contracts are easier to enforce and allow companies to evaluate whether insider trading restrictions will add to the company's value.[67]

This paper agrees with the inherent difficulties in enforcement,[68] however concludes that private contracts are not the most effective substitute to regulation. This is because the relevant transaction and enforcement costs of prohibiting insider trading by contract are too high for each firm. Each company will need to make a new contract every time the need for it arises, thus private confidential contracts will be less cost-efficient than mandatory

[63] Burton Malkiel *The Efficient Market Hypothesis and Its Critics* (Princeton University, CEPS Working Paper No 91, 2003).

[64] Brooke Masters "Financial scandals prove all but impossible for prosecutors" *The Financial Times* (online ed, 30 January 2016).

[65] M Freeman, M Adams, and L Semaan "Insider Trading a Necessary Evil for Efficient Markets? An International Comparative Analysis" (1999) 17 C & S LJ 26 at 222.

[66] At 227.

[67] At 228.

[68] See part VI of this paper.

regulation.[69] Private enforcement of contractual prohibition against insider trading involves diseconomies of scale.[70] Every individual corporation has to bear the considerable costs of detecting and punishing violations of contractual prohibitions against insider trading. Further, to the extent that private companies cannot impose criminal penalties, which are necessary to deter insider trading, as the possibility of detecting it is so low, private enforcement is ineffective in comparison to a national regulatory body.[71] Leaving the decision whether to prohibit insider trading to the company could empower insiders to exploit shareholders.[72] Directors could manipulate decision-making and contracts to their advantage, for example, convincing shareholders to allow insider trading.

F Conclusion

These theoretical debates as to the rationale for and against insider trading should not obscure the fundamental point that an overwhelming consensus of international opinion now firmly considers insider trading to be pernicious. The implementation of regulation for insider trading by most countries with financial markets is somewhat difficult to reconcile with the deregulation view. There is clearly a dichotomy between fairness and market efficiency, which regulation attempts to balance. This paper argues for the sacrifice of the potential economic gain from unfettered insider trading in order to establish secure share markets reflecting non-economic benefits of fairness, integrity and just rewards for all participants. Therefore, the market fairness and market efficiency approaches are the superior rationales.

IV New Zealand's legislative history

New Zealand's legislative framework has not always focused on the market fairness and efficiency rationales. This section provides a brief overview of the numerous changes in the past thirty years, in order to emphasise the inherent uncertainty in how to structure insider trading legislation in the most effective way.

The regulation of insider trading in New Zealand has been markedly erratic. Before the enactment of the Securities Markets Act in 1988, New Zealand had no formal prohibition

[69] Hui Huang *International Securities Markets: Insider Trading Law in China* (Kluwer Law International, The Netherlands, 2006) at 108.

[70] Frank Easterbrook "Insider Trading, Secret Agents, Evidentiary Privileges, and the Production of Information" (1981) 1981 Sup Ct L Rev 309, at 334. See also Ronald Gilson and Reinier Kraakman "The Mechanisms of Market Efficiency" (1984) 70 Va L Rev 549 at 632.

[71] Richard Posner *Economic Analysis of Law* (4th ed, Aspen Publishers, 1992) at 417.

[72] Huang, above n 69, at 110.

on insider trading.[73] Since then, frequent amendments to the regulation have transpired, along with an important policy shift in 2006. The Securities Markets Act 1988 approached the regulation of insider trading through the application of the fiduciary duty rationale. It defined an insider as a person who had confidential, price-sensitive information that was obtained due to a special relationship with the issuer.[74] Such persons were prohibited from trading or tipping until the information was published or otherwise reflected in market prices. There were no successful prosecutions under this regime as it was extremely hard to gain a conviction, the focal reason for this being the requirement of a connection to the company.

The Fletcher Challenge Inquiry[75] emphasised this high threshold, as there was clearly insider trading occurring in this case, yet it was not caught due to the way the 1988 legislation was drafted. In this case, a confidential email was accidently circulated to the whole office regarding a potential merger through an electronic notice board.[76] An independent contractor of Fletcher, A, believed this was a press release and printed the first page, then faxed it to B, a long-term Fletcher shareholder, at his home.[77] The company removed the email from the notice board half an hour later, accompanied by a warning email sent to everyone with access to the notice board.[78] This stated "persons having read this file must be aware that the information … cannot, under any circumstances be communicated to anyone … if you have copied this file, please destroy it immediately and be aware that having read it, you are deemed an "insider" under the Securities Amendment Act".[79] After receiving this, A rang B and told him to destroy the fax and ignore its contents.[80] B ignored this and left the fax on his desk at home, and a few days later C visited his house, made a copy without B's knowledge and took it with him.[81] C also intentionally leaked this information to the media, describing his motive for doing so as "the reporter would write a story forcing Fletcher's hand into making that public announcement official

[73] Peter Ratner and Cathy Quinn, "Insider Trading" (paper presented to New Zealand Law Society Seminar, Wellington, March 1990) at [1.1].

[74] *Insider Trading: Report to the Minister of Justice* (Securities Commission, 18 December 1987).

[75] New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Ltd in May 1999* (Wellington, 2000).

[76] At [4].

[77] At [5].

[78] At [5].

[79] At [6].

[80] At [6].

[81] New Zealand Securities Commission *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Ltd in May 1999* (Wellington, 2000), at [8].

… the share price would go up in value and I would sell [my shares] and make a profit".[82] Both B and C purchased Fletcher shares in the week following receipt of the leaked page, and sold them for considerable profits.

Alternatively, under the 1988 regime, B and C could be classified as "insiders" if they had a connection with the company or received information "in confidence" from a "principal officer or employee" of Fletcher.[83] Neither B nor C were in any type of fiduciary relationship with Fletcher, so were not caught by the law as insiders under the first option. In terms of receiving information "in confidence", B was forwarded the printed page of the news release from A; however there was nothing on the face of it to suggest the information was being passed on "in confidence" as it was just a copy of the draft release. In terms of C, he obtained the leaked page from B's office. Even if he obtained the information "in confidence" from B, B is not an insider, so C could not be found liable for insider trading. This case highlights the problems with the 1988 regime: both B and C who had made a tangible gain by intentional trading on material non-public information fell outside the definition of "insider" because they were too far removed from the source of the information.

In 2000, the Ministry of Economic Development released a discussion document outlining current shortfalls in the 1988 regime and seeking submissions regarding possible reforms.[84] The focal suggestion was that the regime should focus on the market impact rationale of insider trading to minimise the damage posed to the efficiency and confidence in financial markets - rather than a narrow fiduciary duty rationale focused on a relationship with the listed company.[85] Further, New Zealand's laws should be synchronised with the Australian regime, which focuses on the market fairness and efficiency rationales.[86] Following this discussion, in 2003 the government proposed a new insider trading regime based on the market fairness and market efficiency rationales.[87] This went ahead in the Securities Amendment Act 2006, which introduced a dramatic policy shift in New Zealand's insider trading regulation away from the fiduciary duty rationale. The regime was closely modelled on Australian insider trading legislation, which gives the regulator wide powers to pursue

[82] At [9].

[83] Securities Amendment Act 1988, s 3(1)(e).

[84] Ministry of Economic Development, above n 54.

[85] Keeper, above n 41, at 269.

[86] At 269.

[87] Cabinet Economic Development Committee *Review of Securities Trading Law: Insider Trading* (24 July 2003).

insider trading as a civil or criminal matter.[88] Most importantly, under the 2006 amendment, there is no need for a personal connection between the insider and the listed company.

In 2013, the Government introduced the Financial Markets Conduct Act 2013 (FMCA). This Act replicated the structure and content of the insider trading prohibitions contained in the 2006 amendment, with a few minor amendments. This is the current regime in New Zealand and is analysed at length in part V. This volatile legislation path highlights the uncertainty the legislature faces and the unsettled nature of insider trading legislation in New Zealand. There is a need for certainty in the law, thus the next part of the paper attempts to provide a model structure for New Zealand insider trading legislation.

V Comparative legislation analysis

Parts II and III of this paper confirmed a need for legislation against insider trading, strongly disagreeing with advocates in favour of no regulation. Accordingly, the question becomes what is the most effective structure of such legislation. This section undertakes a comparative analysis of insider trading legislation, encompassing New Zealand, the United States and the European Union. This comparison attempts to clarify whether the reason for New Zealand’s low conviction rate is due to leniently drafted legislation compared to jurisdictions that have success in this field. The application of a case study helps to answer this, through identifying the different outcomes that arise in each jurisdiction from identical facts for each of the six elements of the insider trading offence. On each element, this paper identifies the most effective of the three approaches, in light of the finding in Part II that stricter laws lead to greater deterrence of insider trading.[89]

A Case study

This case study highlights the different legal consequences and policy issues arising from the same fact situation in each of the three jurisdictions. The answer will be centred on New Zealand legislation, using the other two jurisdictions as comparisons to uncover the strengths and weaknesses in New Zealand’s approach.

In January 2016, a listed oil and gas company, Company X, is performing well with its share price currently sitting at $3.10. During the first week of January, Company X conducted an exploration in a new location, discovering a vast new deposit of oil. This

[88] Keeper, above n 41, at 270. See also Gordon Walker and Andrew Simpson ”Insider Conduct Regulation in New Zealand: Exploring the Enforcement Deficit” (2013) 2013 NZLR 521 at 523.

[89] Bris, above n 18; see also Durnev and Nain, above n 19.

deposit was of such quality that it became immediately apparent to those involved that Company X would reap sizeable benefits. Public disclosure of the discovery could not occur until Company X acquired certain rights.[90] In May 2016, Company X is progressing solidly with acquisition of the area, and it looks 90 per cent certain it will succeed. Meanwhile, Bob, Company X's Chief Exploration Officer, begins buying shares in Company X at around $3.20. The discovery remains confidential, and the exploration team is barred from discussing this with anyone, including other Company X employees.

A few days later, Joe, an employee in Company X's in-house legal team picks up his photocopying from the printer and finds on the bottom a file note from a meeting. He reads it and realises it is Bob's from a meeting with a petroleum engineering company. The file note is headed 'confidential' and records the results from a report carried out showing the drilling site will enable Company X to increase oil production by as much as 70 per cent, with a prospective start date of October this year. In light of what Joe has read, he takes a photo of the file note on his phone and sends it to his flatmate, Kate, as she studies Energy Science at University and he thought she might be interested in the discovery. Kate knows this is important confidential information so immediately calls her dad, John, who is a frequent financial market trader and says, "Company X have made a huge discovery, you should buy some shares and give me 20 per cent of the profit you make". He checks the news and realises it has not been announced publicly so calls his broker, tells her he has heard some great private news about Company X regarding a discovery, and asks her to purchase him some shares, that are currently trading at $3.25. The broker also purchases shares in Company X for some of her other clients based on John's assertion.

Company X finalises the acquisition in July 2016, with extraction to begin in September 2016. Since January, the share price has gradually risen to $3.30. Company X makes a public announcement through the NZX website on the 1st of August 2016 informing the market of the discovery of the oil site and the extraction start date. Company X's share price surges and closes at $4.50 at the end of the day following the market's reaction to the positive announcement. Bob, John and the broker all sell their Company X shares in the week following the announcement for around $4.50, reaping sizeable returns of up to 40 per cent. To emphasise this impact, assume Bob purchased 1,000,000 shares at $3.20, and

[90] Financial Markets Conduct Act, s 270 states "listed issuer must notify information in accordance with the continuous disclosure provisions of the listing rules for the licensed market if the information is material information that is not generally available to the market". However, as this is still in the planning phase, it will not trigger this section.

sold them at $4.50. He has made a failsafe $400,000 at the expense of all the public investors who, unaware of the impending oil discovery news, sold him their shares.

The potential issues arising from the case study are: whether the information is classified as "inside information" which involves determining if it is "material" and "non-public"; whether any of the parties who traded based on the information about the discovery are "insiders"; whether any "insider trades" were executed; whether there was disclosure of inside information, and whether there was encouragement to another party to trade based on inside information. The liability of each of these parties under New Zealand, United States, and European Union legislation will be discussed, in order to understand the varying consequences of such actions and highlight the differences in the regimes. It is worth nothing the underlying rationale for regulation alters the scope of each regime markedly. As established in part III, both New Zealand and the European Union base their approach to insider trading on the market efficiency and market fairness rationales. United States legislation, in comparison, is centred on the fiduciary and misappropriation rationales of insider trading.

1 Issue one: is the information "material"?

The parties in question have different levels of information available to them in various formats, which alters the materiality. Bob, as Chief Exploration Officer, clearly knows all the details about the deposit and potential it offers for Company X. Both Joe and Kate have the file note from the meeting with the engineers showing forecast increased production figures. John only knows Company X has made a 'huge discovery', and the broker knows there is 'great news regarding a public discovery'. An analysis follows of the materiality of each of these pieces of information under each jurisdiction's regime.

(a) New Zealand

New Zealand defines material information as "information that a reasonable person would expect to have a material effect on the price of listed securities, if it were generally available to the market".[91] There is uncertainty as to what type of "reasonable person" this test involves. However, following the approach under the related New Zealand decisions,[92] and

[91] Financial Markets Conduct Act, s 231.

[92] See, for example, *Auckland International Airport Ltd v Air New Zealand Ltd* (2006) 9 NZCLC 264 at [57]. In this case, the "reasonable person" was discussed in the context of the continuous disclosure regime. Harrison J equated the "reasonable person" with a sophisticated market participant that is "familiar with the purpose and scope of the regime, the market within which it operates, the statutory consultative process, and the publicly known circumstances of the listed company".

using the Australian courts approach in *R v Rivkin* as a guide, courts appear to be generally in favour of a definition of the reasonable person being someone who is "familiar with trading on the stock market".[93] This person commonly invests in securities and has some level of knowledge about trading on financial markets.[94]

The real difficulty lies in deciding whether a particular piece of information has affected the share price. As stated by the Securities Commission, this decision is "a matter of opinion", being a "proper question for resolution on the evidence of experts familiar with the market".[95] On the facts of this case study, expert evidence will be required to determine whether the oil deposit news was already factored into the price, and whether the reasonable person familiar with trading on the stock market would expect it to have a "material" effect on Company X's shares. In the single New Zealand insider trading trial, *Haylock v Patek*, the High Court found a report given to executives indicating there was significant potential for gas reserves at a particular sight did not meet the materiality threshold.[96] In this case, expert evidence was required; these experts found the share price had a normal volatility range of fifteen per cent.[97] The court decided that the information in the report had to have the potential to influence the share price greater than that fifteen per cent.[98] Due to the uncertainty of the report and the information, and after hearing numerous experts' opinions, the court held it would not have influenced share price greater than the fifteen per cent volatility range of the share. This highlights that "materiality" is quite a substantial hurdle to overcome, and a lot of additional information is required.

Applying this test to the case study, it is evident that the likelihood of establishing "materiality" for each parties' information varies. A court is likely to classify Bob, Joe and Kate's information as material, as the information states Company X's oil production is likely to increase by as much as 70 per cent, which is a vast amount for a large listed company. This would unquestionably affect the share price if it were generally available to the market, and it is unlikely already reflected therein as it has been relatively stable around $3.20 for the most part of 2016. Conversely, both John and the broker have less detailed information about the discovery, however it is still likely experts will find this material,

[93] For the Australian approach of the "reasonable person" see *R v Rivkin* [2004] NSWCCA 7.

[94] *R v Rivkin*, above n 93, at [137].

[95] *Insider Trading: Report to the Minister of Justice*, above n 74, at 6.

[96] *Haylock v Patek* [2011] NZCA 674 at [183]. Note the crown was unsuccessful in this case, the allegations of insider trading were not proved.

[97] *Haylock v Patek* [2009] 3 NZLR 559 (HC) at [433].

[98] At [465]-[467].

due to the scarcity of oil discoveries. It is therefore likely that a common investor on the stock market would consider all forms of information held by the parties' to be "material". Attention must be given to the fact that the severity of this oil discovery is an extreme example, and the test for materiality will be a lot harder to prove for less vital information. For Company X, however, a 32 per cent jump on the day of announcement is likely to be evidence of materiality. The price jump of $1.10, equivalent to 32 per cent, on the day of the announcement also points strongly in favour of all five parties holding material information outside a standard volatility range.[99]

The Australian "materiality" test established in *Rivkin*, which this paper argues is likely to, and should be, adopted by the New Zealand courts,[100] deems information as material if it would likely "influence" persons who commonly invest in securities".[101] The court also provided valuable interpretation factors to assist in determining materiality such as the reliability and source of the information, and evidence of actual price movements after release of the information to the public. This paper believes a New Zealand court should use the deeming provision if an insider trading case arose as the lower threshold will limit the excessive amounts of expert evidence currently required to prove materiality under the New Zealand legislation. This expert evidence will be limited because "influencing" an investor's decision requires less evidence than having to prove a material effect on price. As highlighted by *Haylock*, the current New Zealand materiality test requires a substantial impact on price, whereas the Australian test only requires the information to influence a decision, which can occur with considerably more minor news. As the other elements of insider trading are difficult to prove and require knowledge elements, this paper argues New Zealand should adopt a lower materiality threshold in order to increase the level of investor protection as discussed in Part II.

(b) European Union

The European Union Market Abuse Regulation defines inside information as:[102]

> "information of a precise nature, which has not been made public, relating, directly or indirectly, to one or more issuers, and which, if it were made public, would be likely

[99] The evidence of actual movement when information was released was a factor considered when determining materiality in Australian case *R v Rivkin*, above n 93, which is discussed in depth in the next paragraph.

[100] As the New Zealand insider trading regime was effectively transplanted from Australia, its case law is of aid to interpretation of the New Zealand statute.

[101] *R v Rivkin*, above n 93, at [51].

[102] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, Art 7, s (1)(a).

> to have a significant effect on the price of those financial instruments or on the price of related derivative financial instruments".

The Market Abuse Regulation confirms that information likely to have a "significant effect" on price is information that a "reasonable investor would be likely to use as part of the basis of his or her investment decisions".[103] Under the reasonable investor test, the court considers whether the information is such that a reasonable investor would be likely to use it as part of his or her investment decision, even if it would not move the price of the relevant securities in any significant way.[104] The wording of this reasonable investor test is arguably broader than the United States approach below, and clearly wider than the New Zealand approach. All parties in the case study would "use" the information about the oil discovery as "part of the basis of" their investment decisions, which satisfies the European Union materiality test.

(c) United States

United States courts apply the *TSC* test when determining materiality, which has been the "single, judicially created and construed, legal standard applicable to materiality determinations … for over fourteen years".[105] A piece of information is material "if there is a substantial likelihood that a reasonable shareholder would *consider it important* in deciding whether to trade",[106] and that it would "alter his perception in making his investment decision about that security".[107] This is similar to the Australian test, and is far broader than the New Zealand approach. There is no requirement that the information would actually make an insider conduct a trade. Information can therefore be material in the United States if it is qualitative and would not necessarily affect the share price. However, in New Zealand, before qualitative information can be material, it needs to reach the point of potentially affecting the price of the shares.

Applying this broad test to the case study, there is no doubt that a court would find "materiality" for all forms of the information. Despite being predominantly a "reasonable investor" test, the *TSC* judgment also leaves room for the application of market impact factors to supplement an argument that the information was material. Under the market impact approach, information will be material if its disclosure would have significantly

[103] Article 7, s 4.

[104] Article 7, s 4.

[105] Joan MacLeod Heminway "Materiality guidance in the context of insider trading: a call for action" (2004) 52 Am U L Rev 1131 at 1150.

[106] *TSC Industries v Northway Inc* 426 US 438 (1976) at 1.

[107] *SEC v Texas Gulf Sulphur Co* 401 F 2d 833 (2d Cir 1968).

altered the total mix of information in the market.[108] To determine whether the total mix has been significantly altered, courts have frequently resorted to evidence of price movements to ascertain the significance of the information.[109] Disclosure of any information whatsoever regarding an oil discovery would definitely add to the information currently available in the market. As previously mentioned, the $1.10 increase in Company X shares satisfies this test, adding to the conclusion that the information about the discovery is material. However, this approach has faced criticism, as without evidence of buying or selling shares, there are no clear measures of the significance of the information.[110] On that issue, this paper believes the practicability of the test outweighs this uncertainty, as using this test involves less time, money and thought required by the courts in using expert evidence, making this a considerably more efficient definition.

(d) Conclusion

This comparative analysis confirms that materiality is a "murky" concept.[111] Despite being at the forefront of determination of insider trading, in New Zealand it is arguably an unobservable threshold relying wholeheartedly on the hindsight of both the courts and extensive expert opinions. This issue is largely resolved in the United States and European Union by having a less demanding materiality threshold, more focused on relevance to trading decisions, than on causation of a price movement. In these two jurisdictions, the courts do not demand that the information would have induced the investor to buy or sell, rather requires that it "assume actual significance" in the investor's deliberations.[112] The breadth of both the United States and European Union approaches eliminates New Zealand's burdensome step of expert evidence. In *Haylock*, the technical and expert evidence required by the New Zealand court extended to several hundred pages, all of which was highly detailed, complex and technical in nature.[113] By adopting any of the above-discussed three alternative approaches, New Zealand can enhance the strictness of its materiality determination, while concurrently reducing the requirement for such heavy expert research.

[108] *Basic Inc v Levinson* 485 US 224 (1988) at 232.

[109] Yvonne Ching Ling Lee "The Elusive Concept of Materiality under U.S. Federal Securities Laws" (2004) 40 Willamette Law Review 661 at 655. This is also similar to the Australian approach.

[110] Richard C Sauer "The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws" (2007) 62(2) The Business Lawyer 317 at 323.

[111] Glenn Miller "Comment, Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality" (2000) 361 Northwestern University Law Review 389 at 363.

[112] *TSC Industries v Northway Inc*, above n 106, at 44; James Cox "An Outsider's Perspective of Insider Trading Regulation in Australia" (1990) 12 Syd LR 455 at 470.

[113] *Haylock v Patek*, above n 96, at [136].

2 *Issue two: is it "non-public" information?*

There is no concrete line regarding the exact time information transforms from "non-public" to "public" information[114] in any of the three regimes. However, this step is reasonably more straightforward that the above "materiality" element.

(a) New Zealand

In New Zealand, information is public if it has been released into the public domain, or is capable of being obtained from the public domain.[115] Section 232(1) of the FMCA states information is public, or generally available to the market:[116]

> (a) if –
> (i) it is information that 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 relevant financial products; and
> (ii) since it was made known, a reasonable period for it to be disseminated among those persons has expired; or
> (b) if it is likely that persons who commonly invest in relevant financial products can readily obtain the information; or
> (c) if it is information that consists of deductions, conclusions, or inferences made or drawn from either or both of the kinds of information referred to in paragraphs (a) and (b).

On application to the case study, market participants clearly cannot readily obtain the information Bob holds, as only those employees involved in the exploration have access to it. Joe, also an employee of Company X, found the information at a printer at Company X's offices, thus also not readily available to the market external to Company X. Issues arise when considering the remaining three parties. Kate received a photo of the file note headed "confidential" from her flatmate, a Company X employee. It is unlikely the courts will classify this as generally available, as it is still not "likely that persons who commonly invest in relevant financial products can readily obtain the information".[117] This same analysis is likely to apply to the information that both John and the broker hold as well. If either of them tried to find out more about this 'discovery', they would not be able to do so as it is not in the public domain at all. If the market did know, it is

[114] Robert A Prentice "The Internet and its challenges for future of insider trading regulation" (1999) 12(2) Harv J L & Tech 255 at 268.

[115] Financial Markets Conduct Act, s 232.

[116] Sections 232(1)-(3).

[117] Section 232(1)(b).

likely the price would reflect this, which is not the case, as the price remained relatively stable throughout this time. However, this is a relatively clear-cut example, and in many cases, expert evidence will be required to determine whether the market was already aware of the information.

(b) United States and European Union

Both the United States and the European Union have similar approaches to New Zealand that lead to the same result in the case study. For example, in the United States, information is non-public unless it publicly disseminated through, for example, a public filing with a regulatory authority, press release or prospectus.[118] European Union legislation does not elaborate on the definition of non-public, except to indicate that research and estimates developed from publicly available data should not be regarded as non-public information.[119] This will likely be interpreted in a similar manner to the other two regimes. Therefore, there is no material difference in the three approaches, and therefore no changes to the New Zealand regime are required.

3 Issue three: are any of the parties information "insiders"?

The above two issues have determined the information regarding the oil discovery is both material and non-public. Therefore, the information meets the definition of "inside information". The forthcoming issues concern whether insiders of Company X have used this inside information to trade shares and profit illegally.

(a) New Zealand

In New Zealand, s 234 of the FMCA states an "information insider" of a listed issuer involves the satisfaction of two elements:[120]

> (1) the person has material information relating to the listed issuer that is not generally available to the market;
> (2) knows or ought reasonably to know that the information is material information and is not generally available to the market.[121]

[118] Moody's "Policy for Material Non-Public Information" (3 June 2013) Moody's Investor Service <www.moodys.com> at 2.

[119] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, s 28.

[120] Financial Markets Conduct Act, s 234.

[121] Section 234(1); Cabinet Economic Development Committee, above n 87, at 6.

This paper has ruled that all of the parties hold material non-public information, signifying that s 234(1) is satisfied. Concerning s 234(2), Bob will satisfy this subsection, as he is a senior executive of Company X therefore would know it is not publically available. Joe, through his position as an in house lawyer ought reasonably to know the information is material and not publically available. Despite Kate having no relationship with Company X, New Zealand law can classify her as an insider.[122] She is likely to satisfy s 234(2) as she knows of the importance and confidentiality of the information, and told her father with the intention that he uses this confidential knowledge to buy shares and make a profit. A court will also likely hold John to be an insider, as he purposefully checked the information *was not* publically available before he used it. The broker will be an insider due to her occupation, as she ought to have reasonably known it was material and non-public, and should not have used that information to trade other clients' shares.

S

(b) European Union

The European Union takes a similar, but more detailed approach to the definition of an insider.[123] The 2014 Market Abuse Regulation (MAR) imposes insider trading prohibitions on five classes of persons. An insider is any person who possesses inside information as a result of:[124]

> (a) being a member of the administrative, management or supervisory bodies of the issuer or emission allowance market participant;
> (b) having a holding in the capital of the issuer or emission allowance market participant;
> (c) having access to information through the exercise of an employment, profession or duties; or
> (d) being involved in criminal activities.
> (e) this Article also applies to any person who has obtained inside information under circumstances other than those referred to [in (a) to (d)] where that person knows or ought to know that it is inside information.

In relation to the case study, Bob and Joe come within (c) as they have accessed the information through their employment at Company X. This allows the court to automatically classify them as information insiders. The other three parties need to fall

[122] No personal connection is required with the company under the Financial Markets Conduct Act. See Part IV of this paper for further explanation of this matter.

[123] Niamh Moloney *European Union Securities and Financial Markets Regulation* (3rd ed, Oxford University Press, Oxford, 2014) at 723.

[124] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 8(3).

within (e), and the analysis of this will be identical to the aforementioned New Zealand approach. The core difference between the two regimes is the European Union legislation's division of insiders into two groups – automatic insiders,[125] and those requiring knowledge that the information is inside information.[126]

(c) United States

Both the New Zealand and European Union definitions of "insider" sit in stark contrast to the United States approach. The predicate of an insider in the United States is the "existence of a fiduciary relationship" with the shareholders of his or her company.[127] Because of this relationship, the insider cannot trade in order to prevent him or her from taking unfair advantage of the uninformed shareholders.[128] In addition, *Newman* held liability extends to someone who does not have a fiduciary relationship with shareholders, where he or she misappropriates information from a Company and trades in breach of duty owed to that Company who is the owner of the information.[129]

On the facts, only Bob and Joe have fiduciary relationships with Company X, so are both information insiders. Following the courts application of *Yun*, it is unclear whether non-business relationships, such as husband and wife; provide the duty of loyalty and confidentiality necessary to satisfy the misappropriation theory.[130] Therefore, as Kate and Joe are flatmates, the classification of Kate as an insider is unlikely. There is no possibility for either John or the broker to be insiders under the United States approach, as they are too many steps removed from the company, and they have not misappropriated the information from Company X in any way.

(d) Conclusion

This paper is in favour of the European Union and New Zealand approach, arguing the United States legislation is too narrow for the categorisation of insiders. The manner in which you receive information should be irrelevant.[131] This paper argues unauthorised uses of insider information should automatically impose liability on the recipient and any other person who takes this information with knowledge of the illegality. For instance, Kate,

[125] Article 8(3)(a), (b), (c) and (d).

[126] Article 8(3)(e).

[127] *Dirks v SEC*, above n 27, at 653.

[128] Exchange Act 17 CFR §240, s 10(b).

[129] *United States v Newman* 773 F 3d 438 (2d Cir 2014).

[130] *SEC v Yun*, above n 36.

[131] Richard Epstein "Returning to Common-Law Principles of Insider Trading After *United States v. Newman*" (2016) 125 Yale LJ 1150 at 1162.

John and the broker should have the potential to be insiders regardless of their perceived distance in the chain of recipients of the original as they knew it was illegal.

In deciding between the list approach of the European Union, and New Zealand's two-step test, this paper suggests New Zealand adopt the listing of categories. As the European Union's listing approach is in its infancy, it does have a number of current limitations. First, art 8(4)(b) does not specify how large the relevant holding must be before the prohibition attaches. The holding must be such, however, that 'as a result' of that holding, the person possesses inside information.[132] Therefore, this subsection appears to be designed to target large institutional shareholders. Second, art 8(4)(c) becomes blurred where the inside information is not related to the employment in question and is acquired by chance, albeit in the course of occupation such as a taxi driver who overhears a conversation.[133] However, using this approach will enhance the strictness of New Zealand's legislation, as it will catch those in a listed class every time; they cannot escape liability through a technicality. It will likewise minimise time spent by courts applying the knowledge test, as certain classes of people are automatically classified as insiders, providing more practical certainty.

4 Issue four: have any of the parties breached the prohibition on "trading"?

Insiders themselves cannot acquire or dispose quoted financial products of the relevant issuer using inside information in any of the three regimes.[134] This is a relatively straightforward application under New Zealand and European Union legislation, but becomes unclear when considering liability in the United States.

(a) New Zealand and European Union

Recall that a person becomes an insider in both New Zealand and the European Union as soon as he or she has possession of inside information and knows or ought reasonably to know that information is inside information. As soon as all four parties in the case study came into possession of the inside information regarding the oil deposit, and purchased shares in Company X, they became liable for insider trading. Under both pieces of legislation, all four parties in the case study who purchased shares have breached the trading prohibition, regardless of how they received the information. [135]

[132] Moloney, above n 123, at 723.

[133] Other examples include a printer company worker, or a waitress.

[134] Financial Markets Conduct Act, s 231; Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, s 23; Securities Exchange Act 1934, ss 16(b) and 10(b).

[135] Further issues arise from the facts that are outside the scope of discussion of this paper. For example, Company X can also be liable if Joe or Bob's actions can be attributed to it through the Companies Act. There is however a defence available to the company in s 261 of the Financial Markets Conduct Act if they

Interestingly, the European Union has widened the scope of "buying or selling" shares in the Market Abuse Regulation 2014 to include a retrospective type provision. Using inside information to "cancel or amend existing orders" placed before the person possessed inside information, based on the new inside information is insider trading.[136] In addition, the MAR also catches 'attempting' to engage in insider trading within its definition.[137] This has further enhanced the strictness of the European Union regime.

(b) United States

The Supreme Court has defined insider trading to only encompass instances where the insider violates a fiduciary duty to shareholders.[138] Bob and Joe will definitely satisfy this requirement as employees of Company X. However, this is difficult to satisfy for the other three parties.

The recent *Newman* decision held that for a person to be guilty of insider trading when provided with a 'tip' from an insider, it must be shown that the insider providing the tip (the tipper) received a tangible benefit, and the person receiving the tip (the tippee) knew that the tipper was receiving a benefit in exchange for the information.[139] For example, Kate, who received a "tip" from Joe, is unlikely to be liable (if she herself traded) because Joe did not receive a tangible benefit from sending the file note to her. Joe sent it because he thought she would be interested in the details of the discovery from an academic point of view. This absence of liability is supported by *Newman,* which defined "benefit" narrowly, as 'some consequence', more than the 'ephemeral benefit of the value of friendship'.[140] The analysis differs for the interaction between Kate and her dad. Kate asked her dad, John, for 20 per cent of the profits, which is likely to be seen as a tangible benefit by the courts, and John will potentially be liable for insider trading. Despite this, as previously determined in paragraph 4(b) above, defining Kate as an insider of Company X is unlikely due to the lack of fiduciary relationship. Therefore, a not-guilty finding by the court is a probability for both Kate and John, regardless of the arranged tangible benefit,

have Chinese Walls in place. Additionally, in terms of the broker, s 251 a defence is available to her if the other clients' shares she traded were according to the terms of a fixed trading plan. Further examination of these two defences is outside of the scope of the paper.

[136] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 12.

[137] Article 14.

[138] Such as when an employee personally benefits from a leak of non-public information.

[139] *United States v Newman,* above n 129.

[140] At [22].

(c) Conclusion

In effect, the *Newman* decision means that in the United States it is not necessarily illegal to buy or sell shares using inside information.[141] In New Zealand, critically, it does not matter whether the person (tipper or trader) makes a profit or gains a benefit from trading (or tipping another person who trades). Prohibition should apply wholly without regard to whether the party who leaked the information received some return benefit, tangible or intangible. Even the United States government acknowledged *Newman's* personal benefit requirement will "dramatically limit the ability to prosecute some of the most common, culpable, and market-threatening forms of insider trading".[142] This paper again argues in favour of the New Zealand and European Union approach, with a suggestion that New Zealand also include the two supplementary European Union requirements, both retrospective orders and attempts. Justification of this is inherent through the Crimes Act, as attempts to commit crimes under that Act are illegal, hence insider trading should be legislated in line with this.[143]

5 Issue five: have any of the parties breached the prohibition on "disclosing"?

(a) New Zealand

Under New Zealand law, s 242 of the FMCA states the insider (A) cannot disclose information to another person (B) if they know or ought reasonably to know the person will or is likely to trade the quoted financial product or encourage a third person (C) to trade or hold that product.[144] Joe is unlikely to have breached this prohibition. His intention to disclose the file note to Kate was for her interest as he thought it might be relevant to her study. It is improbable a court will hold that he ought reasonably to know that Kate would encourage her dad to trade Company X shares. This is a limitation of the New Zealand legislation, as anybody could claim there was a reason such as this to avoid prosecution. Kate is more likely to be liable under s 242 for disclosure to her dad. She knows her dad frequently trades shares, and disclosed the information to him for this exact purpose. John, given that the person he disclosed the information to a share broker, clearly ought reasonably to know the broker would trade, as that is her job, so would be liable as well.

[141] Jon Eisenberg "How *United States v Newman* Changes *The Law*" (3 May 2015) Harvard Law School Forum on Corporate Governance and Financial Regulation <corpgov.law.harvard.edu>.

[142] Bharara, above n 4.

[143] Crimes Act 1961, s 72(1): "Every one who, having an intent to commit an offence, does or omits an act for the purpose of accomplishing his or her object, is guilty of an attempt to commit the offence intended, whether in the circumstances it was possible to commit the offence or not".

[144] Financial Markets Conduct Act, s 242(1).

(b) European Union

Insiders cannot disclose inside information to another person except when making this disclosure in the normal exercise of employment, profession or duties.[145] *Grøngaard* held a “close link” was required between the disclosure and the exercise of employment, disclosure must be strictly necessary for their exercise; and the sensitivity of information must be considered.[146] This European Union approach is one of strict liability compared to the New Zealand standard. Therefore, it is harsher, and thus John will be liable in the European Union for sending the file not to Kate, even though he had no knowledge that she would trade, or encourage her dad to trade.

(c) United States

In the United States, the only party with potential liability for breaching this provision is Kate. However, this is discussed in light of the unlikely finding by a court that Kate is an insider of Company X. In the United States, mere disclosure of inside information is insufficient to constitute a breach of an insider’s fiduciary duties.[147] The purpose of the disclosure is determinative as to whether a breach has occurred. Disclosure for personal benefit is the component that transforms a casual conversation into insider trading.[148] This reasoning of the United States seems ineffective, as people in positions who overhear information, or receive it by accident can exploit this and be free from insider trading liability. However, at the time of writing, *Salman v United States* is before the Supreme Court, that is seeking to solve the issue of whether insider trading prosecutions require that corporate tippers receive something of value in return for disclosing market-sensitive information.[149] This is “potentially the most important case for market professionals in over 30 years”,[150] as there is the possibility of removing the personal benefit element.

(d) Conclusion

The European Union approach produces the more effective and affords investors the most protection. It is a mistake to require a court to show that a tippee who receives inside information supplies any form of benefit to the insider before the tippee is subject to

[145] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 10(1).

[146] Case C-384/02 *Grøngaard and Bang* [2005] ECR I-9939, at 48.

[147] *Dirks v United States*, above n 27.

[148] Michael S Schachter “The Accidental Tipper: Personal Benefit Requirement for Insider Trading” (2010) 244 NY LJ 61 at 70.

[149] David L Lynch “Supreme Court tackles insider trading law” *The Financial Times* (Washington, 5 October 2016).

[150] Lynch, above n 149.

criminal prosecution. The simple status of the tippee as donee or bad-faith purchaser of improperly released information should suffice.[151] This paper argues the most effective approach is the strict liability of the European Union, and suggests New Zealand alter its law to match this standard. This paper argues that regardless of John's mens rea, liability should arise for disseminating confidential information regarding a public issuer. This is due to the viral effect of such disclosure, as once one person has access, there is nothing stopping them from distributing that information forthwith.

6 Issue six: have any of the parties breached the prohibition on "encouraging"?

In New Zealand, insider A strictly cannot "advise or encourage"[152] B to trade or hold the quoted financial product of the listed issuer, or advise or encourage B to advise or encourage C to trade or hold that product.[153] This is regardless of whether the insider actually discloses the inside information. The European Union advances a more or less identical approach to New Zealand. An insider cannot recommend that another person engages in insider trading or induce another person to engage in insider trading based on the inside information.[154] Additionally, in the European Union, attempting or inducing another person to engage in insider trading will also be caught within the MAR,[155] but it is unclear whether such attempts will come within the scope of the New Zealand regulation. In the United States, it is not an offence for an insider with knowledge of inside information to simply recommend or encourage another to trade.

The two people with potential liability under New Zealand and European Union law are Kate and John. Kate will unquestionably be liable through her explicit instruction to her dad to trade. John's encouragement to the broker is questionable. In *Citigroup,* the court decided the comment "I'd advise you not to buy any more" was not encouragement to trade on inside information.[156] This paper argues New Zealand's approach to this element of the insider trading offence is satisfactory.

B Overall conclusion

Surprisingly, this paper finds New Zealand's legislation structure is not overly erroneous compared to the European Union and the United States. An interesting finding is that in

[151] Epstein, above n 131, at 1151.

[152] This is defined in s 6 of the FMCA as "incite, counsel or procure".

[153] Financial Markets Conduct Act, s 243(1).

[154] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 14(b).

[155] Article 14.

[156] *ASIC v Citigroup Global Markets* [2007] FCA 963. NZ likely to follow this as exact wording of provision in Australia was transplanted into the FMCA.

general, the United States law does not reach far enough, which confirms the inherent weaknesses in the fiduciary duty rationale for insider trading.[157] However, in order for New Zealand to further bolster the strictness of its legislation, and afford investors enhanced protection, this paper makes the following suggestions:

- Reduce the threshold for materiality to "if there is a substantial likelihood the information would alter the perception of a reasonable investor in making his investment decision about that security".
- Transplant the European Union's list of classes of persons who are automatically deemed as insiders on a strict liability standard.
- Alter the offence for disclosure of inside information to one of strict liability.
- Introduce offences for "attempting" to trade, disclose or encourage inside information, and for retrospectively cancelling/amending orders once coming into possession of inside information.

Overall, this paper finds in summary that it is unlikely the sole reason for New Zealand's low conviction rate is due to leniently drafted legislation. Therefore, the paper now turns to penalties and enforcement mechanisms.

VI Deterrence: penalties and enforcement

Deterrence of insider trading occurs through both the severity of the punishment in the form of sanctions, and the probability of detection and prosecution through enforcement.[158] Bearing in mind the overall objective of having the most stringent regulation approach, this part of the paper investigates New Zealand's insider trading penalties, along with its enforcement strategy.

A Penalties

Both civil and criminal penalties are available for insider trading offences, with research showing strong support for the importance of hefty sanctions.[159] Sanctions with the strongest deterrence effect ensure insiders cannot profit if caught, and face significant penalties proportionate to the size of their trading profits. The rationale underlying this is that it is likely insiders will weigh the expected monetary penalty (if caught) against their

[157] However, this appears inconsistent with La Porta and others findings regarding countries with a common law origin. As discussed, they found common law countries were stricter. However, this leniency could be made up for through the United States robust enforcement policies.

[158] Gary Becker "Crime and punishment: An economic approach" (1968) 76 Journal of Political Economy 169 at 172.

[159] See generally, Bris, above n 18. See also and Bhattacharya and Dauok, above n 23.

expected profits from engaging in insider trading. If monetary penalties are less than proportionate to profits, then their deterrent role is weak, holding constant the probability of detection.[160] This section analyses whether the presence of enhanced criminal sanctions actually deters insiders from trading.

In New Zealand, "only egregious violations of securities law" are the subject of serious criminal offences".[161] An information insider in New Zealand faces civil penalties not exceeding NZD 1 million if they breach any of the trading, disclosing, or encouraging prohibitions[162] with constructive knowledge of the elements of the defence. Criminal penalties are available if the insider has actual knowledge of the defence elements. The insider will be criminally liable for imprisonment of up to five years, and/or a fine of up to NZD 500,000.[163] The United States penalties dwarf this. Civil liability is the greater of USD 1 million or three times profits, with criminal liability a maximum of USD 5 million.[164] In the European Union, the MAR requires member states to impose criminal penalties of not less than four years imprisonment, and fines of at least three times the profit made from market abuse, or fines up to EUR 5 million.[165] In terms of civil liability, the European Union does not prescribe set penalties; it varies across the member states. As an example, in France, the Financial Markets Regulator can impose fines on individuals not exceeding EUR 15 million or ten times the amount of profit realised.[166]

1 *Standard of proof*

To compare the two types of New Zealand penalties (criminal and civil), assume the FMA is trying to prove an information insider has "disclosed" inside information to another person under s 242. Civil liability arises if objectively the insider ought reasonably to have known the information was inside information, and ought reasonably to have known the "tippee" would or was likely to trade or hold, or advise or encourage another person to trade or hold those products.[167] For criminal liability to arise, the insider must have actual

[160] Laura Beny *A comparative empirical investigation of agency and market theories of insider trading* (Harvard Law School, Discussion Paper 264, September 1999) at 24.

[161] Cabinet Economic Growth and Infrastructure Committee *Securities Law Reform* (February 2011) at 191-192.

[162] Discussed above in part V (B) (3-6) of this paper.

[163] Financial Markets Conduct Act, s 244(2). Note body corporates can be fined up to NZD 2.5 million.

[164] Financial Markets Conduct Act, s 385(2).

[165] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 7(2).

[166] French Monetary and Financial Code, art L 621-15-2.

[167] Financial Markets Conduct Act, s 244(1).

knowledge the information was inside information, and actual knowledge the secondary party would trade or encourage.[168]

The burden of proof required in criminal cases for actual knowledge is considerably higher. Courts decide civil cases on the balance of probabilities, whereas criminal cases require a finding beyond reasonable doubt. As insider trading prosecution is largely based on circumstantial evidence, the "beyond reasonable doubt" standard is especially difficult to prove.[169] Proof is especially difficult as there is no identifiable victim and the harm from insider trading is so widely dispersed which enhances the difficulty in detection. Peculiarly, the information that can lead to proof that a breach has taken place is often in the hands of the alleged offender.[170] Therefore, although criminal penalties are more severe, they are undoubtedly less likely to result in a successful prosecution.

The Chairman of the Australian Securities and Investment Commission confirmed that the burden of proof and evidence required in criminal cases is problematic.[171] New Zealand will face these same problems due to the transplant of Australian insider trading law into the FMCA. Duffy summarises the burden of proof issue in Australia as follows:[172]

> Regulators will often find themselves in a position where they can identify a person with inside information on a particular security, a person who traded in that security, a relationship between the two persons and even evidence of communications between them (such as telephone records). This however may still not be enough unless there is some evidence of the content of the communications and, in particular, the conveying of price sensitive information that was not generally available. Further, though a circumstantial case for communication may exist, it is usually necessary to establish what was said to identify it as price sensitive information. Also, given the seriousness of such an allegation it is unlikely that evidence of such communication can be inferred from the surrounding circumstances.

[168] Section 385(2).

[169] Frijins and others, above n 20, at 206.

[170] S Rubenstein "The Regulation and Prosecution of Insider Trading in Australia: Towards Civil Penalty Sanctions for Insider Trading" (2002) C & S LJ 89 at 111.

[171] Tony D'Aliosio, Chairman of the Australian Securities & Investments Commission "Insider trading and market manipulation" (speech to the Supreme Court of Victoria Law Conference, Melbourne, 13 August 2010).

[172] Michael Duffy "Insider Trading: Addressing the continuing problems of proof" (2009) 23 Aust Jnl of Corp Law 149 at 155.

Another issue arises when an insider dealer is able to point to an explanation as to his or her trading motive, which may sow sufficient seeds of doubt.[173] For example, if questioned about a particular share purchase, a trader may identify there were rumours circulating, or that he or she cannot remember the reasons behind the purchase. He or she could further claim they were closely monitoring the market, and seeing bid volumes increase, speculated on an imminent price rise. On subsequent questioning, and given time to conduct retrospective research of all publicly available information, a trader can formulate an "explanation" as to why they purchased the shares through piecing together news articles, analyst reports and other information sources that ex post justify his or her decision to trade.[174] The identification of such information in the market will also cast doubt in juries' minds as to the "non-public" nature of the alleged information.

2 Conclusion

This paper suggests New Zealand bolster its penalties by adjusting the fine for civil liability to the maximum of NZD 500,000 or three times profit gained from the insider trading. Under the current model, an insider convicted of civil insider trading liability could effectively make NZD 2 million in profit, and only be liable to pay a NZD 1 million fine. This suggested amendment will ensure an insider trader can collect no profit, which may be more successful in deterring large-scale insider traders.

However, criminal penalties pose ongoing issues due to the high standard of proof required. A recent study conducted in New Zealand found the introduction of criminal sanctions in 2008 was not successful in reducing the impact of insider trading.[175] The study collected data for NZX listed companies before, and following the date the criminal penalties came into effect.[176] It "explored the changes in four spread-based measures that incorporate the cost of information asymmetry", finding the introduction in fact lead to an increase in the cost of trading and the degree of information asymmetry.[177] This lack of success is probably because "the deterrent value of a criminal offence is further diminished where it is perceived that there is a low chance of conviction". [178]

[173] Rubenstein, above n 170, at 107.

[174] Duffy, above n 172, at 156.

[175] Frijins and others, above n 20, at 232.

[176] This date was 29 February 2008.

[177177] Frijins and others, above n 20, at 230.

[178] Law Commission *Civil Pecuniary Penalties* (Law Commission, Issues Paper 33, 2012) at [4.18].

Therefore, although criminal penalties are stricter on paper, they are less likely to result in a successful prosecution. This confirms the need for New Zealand to strengthen its civil penalty. The inherent standard of proof issues also highlights the fact that enforcement is the real issue at play in New Zealand's insider trading regime.

B Enforcement

As proof of insider trading is persistently difficult to prove, enforcement is the key area that needs to be well operated in order to increase the number of convictions. As noted by Bhattacharya, for insider trading laws to be effective, they must be enforceable, and if they are not in fact enforced, research suggests the country may be better off with no insider trading regulation at all.[179] He suggests that if a law is enacted but not enforced, it will deter some insiders from trading illegally.[180] However, those not deterred will trade with greater intensity.[181] Therefore, effective enforcement mechanisms are likely to have the greatest deterrent effect on insider trading. If insiders view the laws as being enforceable and in turn stop conducting insider trades, investor protection and market quality will improve.

A possible justification for the lack of prosecution could be that there is in fact no insider trading occurring in New Zealand. However, in 2014, the Financial Markets Authority received 12 insider trading complaints from NZX and members of the public, with only two of these proceeding to the investigatory stage.[182] These 12 complaints show there is abnormal and potentially illegal trading activity occurring, meaning it is unlikely that New Zealand's insider trading prohibitions are one hundred per cent effective in deterring insider trading. This being said, a vast amount of insider trading could well be occurring that goes unreported, so the statistic of 12 complaints per year is likely to be a large underestimate of the actual level of insider trading occurring. Also in support of insider trading activity incurring can be seen in submissions made to the Ministry of Economic Development's discussion document in September 2000. These provided "anecdotal evidence that the majority of submitters believed that insider trading exists in the New Zealand market and that it can undermine confidence in our market".[183] This report was released 16 years ago; with technological innovation and enhanced speed and methods of

[179] Bhattacharya and Daouk, above n 23, at 594.

[180] At 592.

[181] At 604.

[182] Financial Markets Authority, above n 39, at 19. In the same period, the SEC charged 87 parties in cases involving trading based on inside information. See United States Securities and Exchange Commission "SEC Announces Enforcement Results For FY 2015" (22 October 2015) <www.sec.gov>.

[183] Ministry of Economic Development, above n 54, at 14.

communication, conducting insider trades is now far easier, and accordingly more likely to occur today, which reinforces the report findings.

New Zealand has an extremely weak enforcement record.[184] The suggested higher civil penalty will have minimal effect if insider trading regulations are not readily enforced. This paper believes the first conviction in New Zealand will lead to significant market improvements and have a strong deterrent effect. Battacharya and Dauouk's study found the cost of equity in a country falls by about five per cent upon the first prosecution of that country's insider trading prohibition, while the mere enactment of the prohibition has no effect on the cost of equity.[185] However, the strengthening of New Zealand's current enforcement mechanisms is required in order for this first conviction to take place.

1 *Current approach*

In New Zealand, the NZX monitors price movements, trading volumes, market releases and other media information to ensure trading on NZX markets remains fair, orderly and transparent, and insider trading conduct obligations are not breached.[186] The surveillance team uses market-monitoring software along with market information from the NZX trading system – databases that update in real time with securities movements and volume statistics from information provided.[187] In-depth analysis is undertaken of abnormal market conduct or trading, and if conduct warrants investigation, NZX then refers that matter to the FMA and/or NZX Regulation team. This monitoring process appears sound and internationally credible; however, NZX takes an arguably submissive approach to the investigatory stage. Its August 2016 "Approach to Enforcement" document outlines numerous steps in the investigation process:[188]

> Our investigations start with a request for a phone call so that we can discuss the conduct we're concerned about. We'll tell market participants what we're interested in understanding. If we have a more complex set of events to discuss, or several queries, we'll send those in writing first. We might ask multiple rounds of questions.

[184] See generally JH Farrar "The Securities Act 1978" (1979) 8 NZULR 30. See also Brian Gaynor "Securities Regulation in New Zealand: Crisis and Reform" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) 10 at 11. See also Peter Fitzsimons "Controlling Insider Trading — The 'Civil' Approach in New Zealand" (1997) 4 Journal of Financial Crime 309.

[185] Bhattacharya and Daouk, above n 15, at 97.

[186] NZX "How Does NZX Regulate Its Markets?" <www.nzx.com>.

[187] NZX "NZX Regulatory Model" <www.nzx.com>.

[188] NZX "NZX Regulation Our Approach to Enforcement" (August 2016) <www.nzx.com>.

> We expect that the market participant will share any and all information it has. Being honest and upfront with information and providing detailed explanations in response to our queries can help to reduce the time an investigation takes. It also ensures that we understand the market participant's own view of the conduct.

A severe limitation of this approach is that it gives insiders time to formulate a well thought out reason as to why they conducted a trade, disclosed information, or encouraged another party to trade. This paper contends that the NZX and FMA should prioritise a modification of the current approach, to limit the ease of insiders having the ability to formulate fabricated reasons to justify their trading behaviour. Although "protecting New Zealand's markets from insider trading is a priority for the FMA",[189] conviction results suggest otherwise, which could be due to an easily circumvented enforcement strategy. A recent New Zealand study investigated New Zealand's enforcement deficit, concluding insider trading has a lower enforcement priority relative to other forms of misconduct in the securities markets.[190] The paper also found the most obvious reason for New Zealand's lack of insider trading enforcement is the "limited resourcing hitherto granted to the responsible agency".[191] This paper will explore a range of options the government could contemplate to address this finding regarding resource distribution, and bolster the regulatory toolkit for insider trading enforcement.

2 Possible new mechanisms

The FMA is unable to obtain warrants to use interception devices in investigations under the Search and Surveillance Act unlike securities regulators in Australia and the United States. This is because the requirement for use of interception devices is an offence publishable for more than seven years' imprisonment,[192] and insider trading only carries a maximum of five years.[193] The aforementioned difficulty in proving communication of material price sensitive information from tipper to tippee will remain elusive because of the lack of witnesses prepared to attest to such communications. Therefore, as proof in itself will remain problematic without permitted use of interception devices, the following suggested mechanisms aim to encourage witnesses to come forward to obtain evidence of communications. It identifies a substitute approach to enable proof of trading in replacement of the current approach.

[189] At 20.

[190] Walker and Simpson, above n 88, at 545.

[191] At 547.

[192] Search and Surveillance Act 2012, s 45: "use of an interception device to investigate an offence is not authorised if the offence is punishable by less than seven years' imprisonment".

[193] Financial Markets Conduct Act, s 244(2).

(a) Bounties (civil)

In the United States, the SEC is authorised to offer bounties to persons who provide information leading to the recovery of a civil penalty from an insider trader.[194] Bounties are offered up to a maximum of 10 per cent of the amount of the civil penalty recovered. The United States justifies the use of bounties as appropriate compensation for the personal consequences of informing to "recompense the informant for damaging his or her standing in the community".[195] This is because informing can possibly end an employee's chances for promotion, and can lead to social shunning.[196] Therefore, a bounty must be of such value to compensate the employee for "liquidating his or her career, and accepting the costs of social stigma that may result from informing".[197]

From an alternative perspective, implementation of bounties may in fact deter employees from reporting or preventing insider trading before it occurs in the hope of receiving a bounty. Additionally, bounties could send out the wrong message to companies, that they "should not do the right thing unless rewarded", which is undesirable where greater motives are eclipsed by corrupt ones.[198] This was the conclusion reached by the New Zealand government when considering the implementation of bounties. The Ministry of Economic Development discussed bounties in its 2002 insider trading discussion document, declaring the ability to pay bounties may provide a tool to overcome the problem of obtaining information about insider trading, by providing incentives for people to come forward with information.[199] At the time, Stephen Franks, former member of the New Zealand Securities Commission also believed "private bounty hunter enforcement is likely to be more vigorous, more flexible and better resourced than relying on Government".[200] However, the legislative process ultimately decided against the implementation of bounties in its 2002

[194] Securities Exchange Act 1934, s 21A(e): "[T]here shall be paid from amounts imposed as a penalty under this section and recovered by the Commission or the Attorney-General, such sums, not exceeding 10 percent of such amounts, as the Commission deems appropriate, to the person or persons who provide information leading to the imposition of such penalty. Any determinations under this subsection, including whether, to whom, or in what amount to make payments, shall be in the sole discretion of any member, officer, employee of any appropriate regulatory agency, the Department of Justice, or a self-regulatory organisation. Any such determination shall be final and not subject to judicial review".

[195] W Kovacic "Private Monitoring and Antitrust Enforcement: Paying Informants to Reveal Cartels" (2000) 69 Geo Wash L Rev 766 at 772.

[196] At 722.

[197] At 723.

[198] R Goodin, "Making Moral Incentives Pay" (1980) 12 Policy Sciences 131 at 139.

[199]Cabinet Economic Development Committee, above n 87, at 68.

[200] "Inside traders better left to bounty hunters" *The New Zealand Herald* (online ed, 30 June 2000).

reforms. This paper agrees, as bounties are only offered for civil offences that require courts to perform a partly subjective and partly objective test. The previously mentioned suggestions to the civil regime should ensure increased civil cases are brought before the courts. It is the "actual knowledge" test in the criminal offence that remains difficult to prove, and a rewards scheme may be feasible.

(b) Rewards (criminal)

Though bounties may be inconsistent with New Zealand practice, the offering of rewards for information leading to convictions for criminal law breaches is a common tool used for law enforcement in certain circumstances.[201] Figures released under the Official Information Act in 2013 showed more than NZD 2 million was paid to police informants over a five-year period.[202] However, these rewards tended only to be for cold case murder and sexual violation offences. Therefore, although it is a possibility, it is hard to reconcile such an approach with insider trading. These rewards are often advertised when crimes remain unsolved for example, if a person has disappeared. Accordingly, rather than police providing rewards ex post, this paper argues for the reward of "whistle-blowers" who voluntarily disclose material information to the FMA leading to a criminal insider trading prosecution.

The Protected Disclosures Act 2000 protects employees who release information to the FMA about a wrongdoing from retribution for doing such.[203] The Act is premised on the disclosure of "serious wrongdoing". It provides that no civil, criminal, or disciplinary proceedings can be taken against a person for making a protected disclosure, or for referring one to an appropriate authority.[204] In terms of insider trading, the FMA encourages people to come forward with information regarding the "use of inside information for profit on the share market".[205] This is a readily available tool of the FMA, but it is assumed people rarely come forward with insider trading information, as there is no benefit in it for them. Therefore, this paper recommends that a financial reward for whistle-blowers who report criminal insider trading activity be introduced in New Zealand.

[201] Edward Gay "Police rewards offered: $800,000 Amount paid out: $0" *The New Zealand Herald* (online ed, Auckland, 30 January 2008).

[202] Siobhan Downes "How rewarding are police rewards?" *The Dominion Post* (online ed, Wellington, 25 November 2013).

[203] Protected Disclosures Act 2000.

[204] Section 18(1).

[205] Financial Markets Authority "Whistleblowing and informants" <www.fma.govt.nz>.

Both the United States and European Union offer financial rewards for whistle-blowing insider trading information. The United States has an impressive rewards system since the implementation of the scheme in the Dodd-Frank Act in 2010.[206] As an example, in 2013, the SEC awarded more than USD 14 million to one whistle-blower whose information led to an enforcement action that recovered substantial investor funds.[207] The European Union has recently shifted its stance on rewarding whistle-blowers. The Market Abuse Regulation that came into force in 2016 orders member states to facilitate whistle-blowing in relation to market abuse and allows them to provide financial incentives to whistle-blowers whose information results in the imposition of sanctions for MAR infringement.[208]

This paper advocates for the introduction of whistle-blowing rewards in New Zealand to bring it in line with stringent international enforcement approaches. Such a system is sure to encourage people to report suspicious trading behaviour.[209] A recent study investigated how to increase an individual's intention to report wrongdoing by incorporating financial awards into the whistle-blowing process.[210] The findings revealed that the participants were most likely to reveal their identity for a financial reward, suggesting that the potential financial rewards outweigh the potential cost associated with being identified as a whistle-blower.[211] Academics advocate for the use of financial enticements in the form of a reward, noting that the motivation for insider trading is financial gain in any event.[212] Additional economic and psychology literature on the theoretical efficacy of rewards in the regulatory context suggests rewards are more useful than punishments in motivating human behaviour.[213] A whistle-blower programme may well lead to information about when a listed issuer's directors and employees learned of material information, allowing the NZX to detect more potential cases of insider trading.

[206] Wall Street Reform and Consumer Protection Act 12 USC § 922.

[207] United States Securities and Exchange Commission "SEC Awards More Than $14 Million to Whistleblower" (press release, 1 October 2013).

[208] Regulation 596/2014 on market abuse (market abuse regulation) [2014] OJ L 173/1, art 32(4).

[209] Diana Clement "Whistleblowing takes nerves of steel" *The New Zealand Herald* (online ed, Auckland, 14 March 2015).

[210] Kelly Richmond Pope and Chin-Chen Lee "Could the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 be Helpful in Reforming Corporate America? An Investigation on Financial Bounties and Whistle-Blowing Behaviours in the Private Sector" 112 Journal of Business Ethics 597 at 601.

[211] At 606.

[212] Chapman and Deniss "Using financial incentives and income contingent penalties to detect and punish collusion and insider trading" (2005) 38(1) Australia and New Zealand Journal of Criminology 122.

[213] J Braithwaite "Rewards and Regulation"' (2002) 29(1) Journal of Law and Society 12 at 12.

Nevertheless, implementing rewards for whistle-blowers requires cautiousness, as regulators will need to ensure people are coming forward for the right motives. This is because whistle blowing in bath faith results in a loss of protections for the discloser of information, and could backfire strongly on the individual. There is also an invariable issue with rewards as to the quality of evidence obtained. The motivation to receive a reward can lead to the motivation to give inaccurate evidence.[214] The legislature has to consider the possibility of inaccurate evidence in the context of the alternative, a more or less nonexistence of evidence. One limitation of the current New Zealand whistle-blowing regime is that only employees get protection. However, under certain other Acts,[215] financial advisers, auditors, supervisors, custodians, investment managers, directors of issuers, promoters and experts may have the ability for their identity to be protected, along with protection from related legal action. This paper suggests expanding the list in the Financial Markets Conduct Act to include any person who provides important whistle-blowing information in relation to abuse of financial markets.

Overall, this paper argues that the possibility of important information leading to successful insider trading prosecutions outweighs the risk of bad faith whistle-blowers losing their jobs. A possible structure of this scheme is to allow a whistle-blower to be eligible to receive up to 15 per cent of the total monetary penalties ordered against the insider trader.[216] This is as long as the information provided by the whistle-blower was voluntary, of high quality, original in nature, and the penalty against the insider trader exceeds NZD 500,000.[217]

This paper's results regarding enforcement confirms the notions of La Porta and others, who state that government intervention is vital in reducing the prevalence and problems associated with insider trading.[218]

[214] *Australian Independent Commission Against Corruption Report on Investigation into the Use of Informers* (January 1993*)* at 58.

[215] Financial Advisers Act 2008; Financial Markets Supervisors Act 2011; Securities Act 1978; Financial Markets Conduct Act 2013.

[216] This is in line with the Canadian programme.

[217] Further research into the boundaries and practicalities of the scheme is outside the scope of this paper, it merely provides an idea for the government to consider.

[218] La Porta and others, above n 13.

VII Conclusion

Insider trading is an indiscernible yet highly problematic manipulation of financial markets. It is a tempting and easy to commit offence that causes covert harm to a multitude of innocent public investors. As this paper has eliminated the option of there being no insider trading occurring in New Zealand, the lack of prohibition results from the combination of insider trading not being discovered, and insider trading being discovered but being unable to be prosecuted. Therefore, this paper concludes there is an unquestionable requirement for enhanced regulation against insider trading in order to afford local and foreign investors in New Zealand financial markets a high level of protection.

In light of the comparative analysis, this paper finds that New Zealand's legislative framework scores highly on some criteria. However, there are nevertheless aspects that require reconsideration to enhance the strictness of the legislation. In particular, this paper concludes that enhancements should be made to the materiality threshold, the disclosure of inside information offence, and the civil penalty amongst other minor alterations. These changes will reduce the number of resources and evidence required to prove insider trading, whilst at the same time increasing deterrence.

The key finding of this paper is that it is the enforcement of law, not having dormant good law that counts. However, the enforcement of insider trading is a complex area. An enhancement to the regulatory toolkit is advanced by this paper through whistle-blowing rewards that will increase the willingness of witnesses to come forward, and assist the regulatory bodies in achieving the high standard of proof. This paper recognises that it is almost certainly ambitious in the likelihood of implementation of the suggested changes and it has not aimed to address the viability of implementing such changes. It has instead provided a model regulation structure for New Zealand to aim towards to reduce the marked enforcement deficit. This paper concludes that law reform of the insider trading regulation is necessary to ensure the continued growth of financial markets and the New Zealand economy. If no action is taken to improve the strictness of the regime, in another thirty years New Zealand may still be waiting for the first person to be convicted of insider trading.

Word count

The text of this paper (excluding table of contents, footnotes, and bibliography) comprises exactly 14,967 words.

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