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INSIDER TRADING

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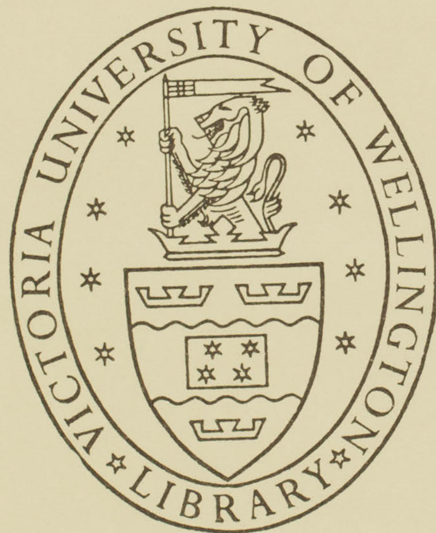
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THE REGULATION OF INSIDER TRADING IN NEW ZEALAND

- PRINCIPLES, PRACTICE AND PROPOSALS FOR REFORM

Research paper for Bodies Corporate
and Unincorporate LL.M. (LAWS 523)

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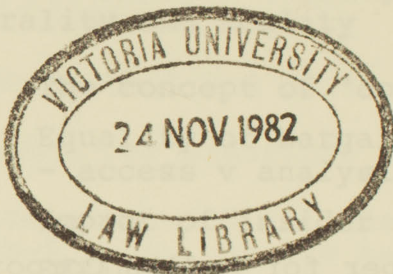

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GLOSSARY

In this paper: the masculine includes the feminine

: 'companies' and 'corporations' are used interchangeably

: 'representative' and 'nominee' directors are used interchangeably

I INTRODUCTION

Recently there has been an upsurge of interest in New Zealand concerning insider trading in general, and its possible regulation in particular. The impetus for this has been the establishment of the Securities Commission,[1] particularly its report on sharebuying activity in Bing Harris & Co. Ltd.,[2] increased judicial consideration as expressed in the celebrated case of Coleman v. Myers,[3] and increased public interest, particularly among large institutional investors as a result of the circumstances surrounding a number of recent take-overs.[4] Discussion of how insider trading should be regulated is particularly appropriate in view of the recent statement by the Chairman of the New Zealand Securities Commission that[5]

> "[W]hen its programme permits, the Commission will undertake a review of the law and practice on the subject."

This paper will first examine the reasons justifying the regulation of insider trading. During this discussion, some of the objectives of any potential regulation of insider trading will be established. Secondly, the current position in New Zealand will be examined in the light of these objectives. Thirdly, various other regulatory schemes will be examined to see whether they would better meet the objectives of regulation in New Zealand. Particular attention will be paid to the legislative alternatives which have been implemented in the United States, Canada, the United Kingdom and Australia, with a view to deciding whether similar legislation should be introduced in New Zealand.

A paper of this nature cannot attempt to answer all the questions in an area as vast, vexed and complex as insider trading. It can at best provide an alternative viewpoint. Therefore, the purpose of this paper is to provide a framework for future discussion of insider trading regulation and to highlight some of the major issues involved.

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II RESEARCH METHODOLOGY

In order to flesh out the objective framework, a series of in-depth interviews was carried out by the author. The people interviewed were prominent New Zealand businessmen.[6] An attempt was made to obtain a representative sample of executive directors, professional directors, representative directors, sharebrokers, insurance company general managers, investment company general managers, lawyers and Securities Commission members. The interview was semistructured and based on a loose series of questions covering the various topics raised in this paper. (See Appendix)

The impressions gained from these interviews have been used to put some relative weighting on the regulatory objectives and to provide a body of opinion on the various regulatory alternatives. In this way it is hoped that the ideas generated by this paper are, to some degree, representative of those who are likely to be affected by insider trading regulation.

III DEFINITION

Inside information is information which is gained by reason of one's position or relationship with a company. It may or may not be of such a nature that, if released, it would have an effect on the market price of the company's securities ('price-sensitive'). In this paper it will be assumed that inside information is price-sensitive.

Insider trading is usually defined to mean the use by corporate insiders and their associates of confidential price-sensitive information, not available to the investing public, which they have obtained by virtue of their position in the corporation, to make a profit or avoid a loss by dealing in the securities of the relevant company.[7] This is a very general definition, and further refinement is necessary.

A. Who is a 'Corporate Insider'

The circle of people whose relationship with the corporation marks them as a 'corporate insider' usually includes directors, senior corporate officers and major shareholders, in its narrowest sense, and may extend to include employees, professional advisors, third parties who are tipped off by an insider (commonly known as 'tippees') among others. This definition of corporate insider is wide enough to include a major corporate shareholder who appoints[8] a director to the board of a company and who receives information about that company through the director. The position of such a director is the subject of some debate in New Zealand at present.[9] Two of the questions to be addressed by this paper will be whether a major shareholder (company or individual) who receives information from such a director should be regarded as an insider, and, if so, whether it should be treated any differently from other insiders.

It is also possible that a person may be an insider in a corporation with which he does not have a contractual relationship. This may occur when his _corporation_ has some form of contractual or special relationship: for example the offeree to the offeror in a take-over situation.

Just as there are various degrees of insider status in terms of the insider's position _qua_ the company, there are various degrees of inside information. As a result of his position in the corporation, an insider will get a more informed view of the corporation's general prospects: for instance that the present management structural changes will improve the long term growth prospects. However, there will be times when he is in possession of a specific piece of information which is likely to have an immediate impact on the share price: for instance that the dividend is going to fall by five per cent this year. A further contrast may be made between information which is uncertain or contingent, and that which is immediate and which may be termed a palpable reality. In most corporate decision-making processes there will be a natural progression from the uncertainty of the drawing board stage to the certainty of the directors' go-ahead to commence full production.[9A]

This lack of definition of what actually constitutes inside information is what makes insider trading such a grey area. However, it can be said that those insiders within the narrowest circle identified above, (i.e. directors and senior executives who are at the top of the corporate decision-making process), are more likely to come into possession of specific and certain information which is price-sensitive. They are also more likely to be in a position where they can appreciate the value of the information because they have a superior corporate perspective.

As one moves out and broadens the circle of people termed insiders, it becomes less likely that they will come into possession of specific price-sensitive information, and also, less likely that they will have sufficient perspective of the whole organisation to be able to fit their piece into the overall 'jigsaw puzzle' and make successful use of it.

The term 'corporate insider' may, then, be seen as a series of concentric circles emanating from the corporation and based on the nature of a person's relationship with the corporation, and the specificity and certainty of the information that he has access to.

B. <u>When Does Insider Trading Occur</u>

It is useful to identify some of the different situations when insider trading may occur because the type of regulation appropriate may well depend on what type of insider trading is being dealt with.

Insider trading may occur within a large, publicly-listed company with a diverse shareholding at one extreme, or within a small, closely-held, family-type, private company at the other extreme.

The method of transaction may range from an anonymous and impersonal stock exchange transaction to a face-to-face dealing. In the case of the latter, the insider may actively approach the outsider, or he may be the passive receiver of an offer.

This paper will focus on the publicly listed company, particularly where the dealing is on the stock exchange. Insiders in private companies do not have a ready market to buy and sell shares on. Therefore they are restricted to face-to-face dealings. If they wish to sell, most private companies' articles give a pre-emptive right to

buy to the other shareholders. These shareholders are likely to participate to some degree in the management of the business, and therefore are likely to have access to the same inside information. If not, the Courts in their equitable jurisdiction are able to find a fiduciary relationship, based on notions of confidence and trust, between the parties.[10] Therefore, it may be said that, in general, different considerations apply to dealings in private companies' shares than to anonymous dealings in public company shares on the stockmarket.

IV TOWARDS A POLICY BASIS FOR INSIDER TRADING REGULATION

A. Policy Objectives of a Securities Market

The formulation of a policy basis for the regulation of insider trading necessarily involves some consideration of the objectives of a securities market. It has been said that the securities market serves three functions: (a) it provides a ready market for securities; (b) it yields prices for securities that are in accordance with their investment value; (c) it acts as a medium for channelling capital into economic development.[11]

If the securities market is going to provide for the ready marketability of securities, there must be as few impediments as possible. Thus the paper-work burden of reporting requirements must be minimised within the constraints of the other objectives. Secondly, if there is to be a ready market, there must be an element of trust in the other side. If there are persons in the market who are not subject to the vicissitudes of the market-place, then this trust breaks down.

In its function of yielding prices for securities that are in accordance with their investment value, the securities market acts as a complex arrangement for the marketing of information.[12] Professor H.G.Manne, the chief proponent of this view, bases his view on 'the fundamental premise that information is a valuable good which will be sought after by human beings who prefer more rather than less of anything good'.[13] The different amounts of profit that individual investors receive will reflect their different degrees of sophistication and the reliability of their information. The stock market is seen as 'par excellence, the arbiter of the value of the information'.[14]

The third function of a securities market is its

most important one. It acts as a medium for the allocation of capital resources into production. In terms of the economy as a whole, the objective of the securities market is to allocate capital to the highest return use possible. Thus a major objective of the regulation of a securities market is that it promotes efficiency. Efficiency refers to both the speed and the accuracy with which the market integrates new information into the market price of a security.

The market price of a security may also be used as a measure of the performance record of management, and the potential profitability of a take-over. This was the subject of comment recently when it was said[15]

> "The takeover is the one area where we have some salutary discipline in the commercial community. If the directors are ultimately inefficient to the point where their share price exposes them to the designs and ambitions of those who think they can do better with the assets, then the directors will lose their job."

Thus, if the securities market is functioning efficiently both the capital and the 'corporate control' markets will function more effectively.

There is another aspect to the function of the securities market as an allocator of resources. To be a successful medium between investors and producers, the securities market must attract investors. It has been truly said 'that the very preservation of any capital market depends on liquidity, which rests in turn on the investor's confidence that current quotations accurately reflect the objective value of his investment'.[16]

Since the price of a security is an indicator of what the buyer and the seller perceive as the true value of the

security, it is essential that both investors have confidence in that price. It is suggested that both parties are prepared to run the risk that the other side may have superior analytical ability. However, they would be much less willing to risk their capital if they thought that the other party was trading on information which they were legally barred from having, particularly if that information made the chance of a loss for them almost a dead certainty.

Thus, to sustain investors' confidence, and hence their willingness to risk their capital by investing in the securities market rather than in, say, government stock, an objective of a securities market must be equality of bargaining power in terms of access to the same information. Therefore, two goals of securities market regulation must be to reward superior analysis of information, and to encourage maximum disclosure of information. In this way the twin objectives of efficiency and equality of bargaining power are met, and the continued flow of investor capital to areas of the economy having the highest marginal return is assured.

B. Possible Areas of Impact of Insider Trading

There are three general levels at which a corporate insider who trades on price-sensitive information may have an impact. First, perhaps at the most narrow and specific level, the insider trader may make a profit or avoid a loss at the other party's (outsider's) expense. For instance, if the information is good, then the outsider will sell at a lower price than he would have accepted had he been privy to the information. Similarly, if the information is bad, the outsider will pay too high a price, allowing the insider to avoid a loss.

Secondly, the insider trader may have an impact on the corporation. Although a corporation is prevented

from dealing in its own shares,[17] it is still possible to envisage situations where insiders, privy to corporate information, may be in conflict with the corporation if they use it for personal advantage: for example, if the information is bad, but is of such a nature that it cannot be released by the corporation, and the insider uses it to sell his shares, thereby depressing the share price. (The share price will go down because the insider will be prepared to offer less than the share price).

The corporation may also be affected if the insider is seen to be involved in opprobrious conduct. This may cause the prestige and goodwill of the corporation to be tarnished. It is true that the corporation has a great interest in maintaining an image of probity and a reputation for integrity.[18] Top management must have the respect and faith of their employees if they are to manage successfully. Public confidence in top management is necessary for the continued marketability of the corporation's securities.

Thirdly, the insider trader may have an impact on the market as a whole. As has already been identified, the securities market serves a vital role in acting as a mechanism for channelling capital into economic development. The investor's decision to invest is determined by his perception of the riskiness of the market. He may be chary or even deterred from investing if he perceives that there are insiders who never get hurt and who are abusing the trust put in them by their employers. This is particularly true of the large institutional investor, or the foreign investor, who have a range of possible markets to invest their capital in. It may also deter some of the larger private companies from going public if unconscionable conduct by insiders is seen to occur.

Thus, it is important to bear in mind that there are

these three levels of impact when possible regulation of insider trading is considered. For instance, in a given transaction it may be impossible to show damage at the narrow level to any individual investor, but it may be possible to show damage at one of the two broader levels.

C. Should Insider Trading be Regulated - Morality and Reality

The most common 'first blush' reaction to insider trading is that it is 'unfair'. It is said that whilst there are always uncertainties inherent in the buying and selling of securities, there should, as a matter of fairness, be an equality of bargaining power between outsider and insider. The insider should not have an advantage over the outsider for a reason that has no merit: namely superior access to corporate information as a result of their jobs.[19] It is considered unfair that by reason of his superior access to information, the insider may cause the outsider loss, or deprive him of gain.

As well as being unfair, insider trading is often castigated as being immoral. It is said that the insider who receives information in his capacity as an officer of the corporation is bound to use it solely for the corporation's benefit. In the case of a director, he is appointed to represent the interests of all the shareholders, not just himself or a few favoured friends.[20] Therefore it is considered to be immoral if the insider uses the information for his own personal benefit.

This approach to insider trading has been criticised by Professor Manne as being self-righteous and hypocritical.[21] He asserts[22]

> "in the entire literature on insider trading there does not exist one careful analysis of the subject. Lawyers have been

> having a field day arguing about the meaning of words or the reach of the last case or any of a thousand technical and legal issues. ...The tone of debate has remained essentially moralistic and question-begging. Logic has been totally lost to emotion".

Manne is perhaps the best known opponent to the regulation of insider trading. He argues his case on the basis of logic and economic sense.[23] It is proposed to examine some of these 'logical criticisms' in the light of the objectives of the securities market that were established earlier, in order to determine whether insider trading does cause harm to other investors, the corporation or the market as a whole.

1. The concept of 'confidence'

Manne cites the celebrated American case of SEC v. Texas Gulf Sulphur Company[24] as an example of the hypocrisy of the fairness/immorality arguments. In that case the directors of a mining company were able to buy shares in advance of the publication of a discovery of a rich vein of copper and zinc. They were held liable, along with the geologist, to account for the profits made. Manne exposes the hypocrisy thus:[25]

> "...Texas Gulf Sulphur officials buying stock with knowledge of a new ore vein have somehow done something immoral, but the company itself buying surrounding land [to increase production capacity], utilising precisely the same information, has merely performed in a business-like fashion" (emphasis added)

To answer this criticism, it is necessary to examine the nature of information as a commodity, and the purposes to which it may be put.

Information is an intangible asset. As such, its use for one purpose does not necessarily exclude its use for another purpose. In the case of a company, if an employee is given a physical asset such as a car, it is primarily given on the understanding that it will be used solely on company business. If the employer uses the car for his private business he is breaking a confidence, as well as diminishing (admittedly minutely) the value of the car. It is not so much the damage to itself that the company is worried about, but rather the breach of trust arising from the relationship between employer and employee.

Applying these principles to company information, if an employee uses information gained through his employment to trade on the securities market, it is not so much the prospect of damage, but rather the breach of trust which labels the conduct as immoral. The insider was given access to the information on the understanding that it would be used for the corporation's business, not for some private purpose.

Information may also be viewed in another light. Information may be regarded as property - an intangible asset of the corporation.[26] As an asset of the corporation it is to be used only by the corporation. Therefore its use should be restricted to corporation business, unless, like any other asset, it is sold or leased out for valuable consideration. If an insider uses corporate information for personal gain on the securities market, he may be said to be misappropriating a corporate asset. The immediate result of regarding information as property is that one of the probative difficulties is overcome, for no matter how many times the information is passed on, it still 'belongs' to the corporation. There is no need to prove some confidential relationship between the parties.

Returning to Manne's example, the difference lies in this: when the corporation uses the inside information to purchase land for a production facility, it is using its own information and therefore breaks no confidence; when the insider uses that information for personal gain he is breaking a confidence. That confidence may be based upon his relationship to the corporation, or it may be based on the information *per se*. It is the breaking of that confidence that is considered immoral.

2. Equality of bargaining position - access v. analysis

Secondly, Manne criticises the resort to equality of bargaining opportunity as a justification for regulating insider trading. The insider obviously has greater knowledge than the outsider because of his position, and thus has a superior bargaining position. Manne argues that one party will of necessity have more knowledge about the factors that will affect the share price than another,[27] but both parties must be aware of this, and accept that risk. No amount of legislation could or should ensure equality of bargaining position.

Manne goes further, and describes the stock market as an information exchange in which a monetary value is placed on information.[28] "In an investment market characterised by risk a high premium will normally be paid for reliable information'. The market rewards the best information, leading to allocative efficiency.

To examine the validity of this argument it is necessary to bear in mind the reasons why one investor does better than another. The price that an investor is prepared to pay for a security is determined by his access to information, his comprehension, his evaluation and his ability to execute. Insiders have superior access to information, not because they are better at

recognising and finding it, but because outsiders are legally prevented from having access to it. If the law is going to protect the right of corporations to prevent outsiders having access to such price-sensitive information (for legitimate reasons such as protection from competitive disadvantage), then it should as a matter of fairness prevent insiders from exploiting that information at the expense of others. It is submitted that investors are willing to accept the risk that others will have superior personal qualities in terms of comprehension, evaluation and even ability to execute. However, they are not willing to accept that some should make profits for reasons unrelated to personal qualities: namely, better access to information.

A useful analogy may be drawn between investing in the securities market and betting on a horse race. The bettor accepts the risk that he may lose out to those with superior analytical skills who take the trouble to look at form and watch the horses in training. However, he would not accept the risk of losing out to those who have inside knowledge that the race is 'rigged'. Manne seeks to distinguish between manipulation and insider trading.[29] The former he sees as 'having the race fixed', the latter a 'reliable tip on a winning horse.' Whilst it is accepted that there are various degrees of insider information ranging from general and uncertain to specific and certain,[30] there will often be times where the insider has more than a 'reliable tip' and 'having the race fixed' would be a closer analogy.

Thus, the insider trader has a superior bargaining position for a reason that is unacceptable to the outsider investor.

3. Impact of insider trading

Thirdly, Manne asserts that the damage caused by insider trading is minimal, even non-existent. He begins by showing that only an extremely small proportion of shares are actively traded, and he asserts that insider trading forms only a very small proportion of market trading.[31] Therefore the evil attributable to insiders, in relation to the total sharemarket, will be negligible.[32]

Manne distinguishes between those who trade in response to price changes and those who trade as a function of time. The latter would trade, even if they thought the price was going to change later. Those who trade on the stock exchange on the basis of price would trade at the going market price, whether it was from an insider or not. So would those in off-market transactions provided there were no misrepresentations or other inducements to trade. If they would have traded anyway at that price, it is difficult to see what loss they have made because of insider trading.

Although the odds of trading with an insider may be small, someone must do. Thus the insider will increase the number of transactions taking place. This will mean that someone who would not have traded had the insider not been on the market, will now trade and suffer loss. Therefore it is not strictly correct to say that, in the case of stock exchange transactions, the outsider would have traded anyway.

It can also be said that the activities of an insider will not always have a minimal effect on the market. In some situations, particularly in relation to an individual stock, insider trading may have a significant effect on the share price. This is likely, for example, when the insider is building up a signif-

icant minority interest based on inside information.

Having established that insider trading is not always of negligible effect, it becomes important to assess whether it does damage other investors or the market as a whole.

Manne asserts that insider trading is <u>beneficial</u> to other investors and to the market as a whole.

If the information is good, suggesting favourable prospects, then the insider will be prepared to offer more than the market price. This means that all investors who sell to the insider before the information is publicly released will receive a higher price than if there is no insider in the market.[33] Similarly, if the information contains bad news, then the price the outsider will pay will be less than he would have paid if there was no insider in the market. The insider will be prepared to accept a lower price. This reduces the average loss that the outsider will suffer when the inside information is released. Of course, by driving the market price up or down as the case may be, the insider is affecting the price paid in <u>other</u> transactions. However, as in these transactions one 'innocent' person's gain is another 'innocent' person's loss, it is submitted that this has no bearing on the insider trading issue.

Examining the 'insider transactions' more closely, some of them will involve outsiders who trade as a function of time, and others who trade as a function of price. In the case of the former, they will receive a higher price or pay a lower price. Thus they will benefit from insider trading. In the case of those who trade as a function of price, they may suffer a loss. This is because they would not have traded had the insider not created a pressure on price. They would have waited until the information was

released to the market, and then would have benefitted from the resulting price change. These price-sensitive investors tend to be short-term speculators who, it may be argued, are not bringing new information to the market. They are merely cashing in on other people's analyses. As such it is difficult to see why they should be the subject of protection for they tend to destabilise the market.

4. Efficiency

By moving the price of the security in the direction of its 'true' price, insider trading improves the efficiency of the market. This has been said to be beneficial on two levels.[34] First, on a societal level, it implies that the market uses all available information to allocate resources. Capital will flow to the most profitable investments which, in a market economy, are reflections of society's values. Secondly, on the level of the individual investor, efficiency implies that no one investor can systematically identify and acquire undervalued securities.

There are a number of reasons why, at any particular time, information has not been publicly released. Some information will never be released voluntarily by the corporation. For instance, news of a personality clash within top-level management that may jeopardise the corporation's future may never reach the market place directly. Sometimes information will not be released even though its release would be in the public interest. An example of this might be a scheme to defraud insurance companies by fabricating false insurance policies and reinsuring them.[35] Information reflecting the general 'feel' for a corporation which is built up as a result of years of experience may also never be released to the market.

Some information's release date will be delayed. This may be because it is conjectural. For instance, a research and development team may estimate that the chances of a successful prototype to turn water into energy are 1:4. Another reason for delay might be that premature release may endanger a transaction which is still to be completed and thus prejudice the corporation.

Thus it can be seen that there are a number of situations that will arise where information will not be generally available to the market, and where a 'full disclosure' rule would not make it available. It may be that in these situations, the only way of 'bringing the information into the marketplace' is by allowing the insider to trade on this information. It may be that this is the only way of maximising the efficiency of the market - in terms of both speed and accuracy.

Therefore, it is suggested that in terms of direct impact on the market the only person who is damaged by the insider is the price-sensitive speculator. In terms of overall market efficiency, everyone is better off. Perhaps the insider's profit is the price to be paid by the market for increased efficiency.[36]

Whilst this may be an attractive argument, there are repercussions of insider trading other than efficiency to be considered which have an impact on the corporation and on the market as a whole.

5. Importance of appearances

Manne may be correct in asserting that in fact insider trading normally forms a minuscule proportion of total market activity but he neglects to consider the impact of appearances on the securities market. An investor's decision to invest is determined by his perception of the securities market as a whole,

and of the stock of the corporation in particular. An investor will not invest in either if he does not have confidence in the integrity of them.

Professor Loss has attacked insider trading on the basis that it[37]

> "...constitutes an even more grievous insult to the market in the sense that the very preservation of any capital market depends on liquidity, which rests in turn on the investor's confidence that current quotations accurately reflect the objective value of his investment. The lawyer's adage that it is important for the courts to appear to do equity might well be borrowed by the economists with reference to the markets."

There seems little doubt that if investors thought there were some big fish in the market pond who were always going to be well fed, they would be deterred from taking the plunge.

It has already been established that the corporation has a very real interest in presenting an image of probity and integrity, both in terms of its management and its stock.[38] If insider trading is seen to occur, then the corporation will suffer real damage in that it will find it much harder to attract investment capital.

If employees perceive that top level management is making gains 'on the side' in addition to their formal remuneration, they will lose confidence in management. They may also feel that they are entitled to such 'extra' corporation benefits. Both of these may be harmful to the corporation.

Thus, even if it is conceded that the initial factual detriment of insider trading to the other party is small, perception of widespread insider trading could seriously damage both the corporation and the market as a whole.

This raises two further questions: is insider trading really perceived to be a serious threat, and, if so, does it deter investors?

It has been suggested that there are far more important psychological and economic factors than the possibility of insider trading that determine public confidence in the securities market.[39] Many investors buy securities for the annual income stream they return. As they do not trade, short-term fluctuations in price do not affect them. Others, who are looking for a capital gain, tend to be short term speculators. They, it may be argued, do not provide a stable source of capital to corporations, and are thus unworthy of protection.

It is also suggested that investors are less concerned with the integrity of corporate executives than with the marketability of the corporation's product. If a corporation shows promising prospects of growth, then the investor is hardly going to be deterred from investing by the possibility that an insider may be in the market.

These are but a few preliminary considerations as to whether insider trading has a damaging effect. The question of whether insider trading actually constitutes a sufficient threat to warrant regulation will be discussed later.[40] However, it may be said with confidence that there will be situations where disclosure of price-sensitive information cannot be compelled, so that the choice becomes one of insider trading or nothing, efficiency or inefficiency.

6. Insider profits as a reward for the entreprenour

Fourthly, and most controversially, Manne argues that insider trading is beneficial in that the use of inside information for personal gain is the one appropriate and adequate way of compensating the entrepreneur. It is said that the prospect of high uncertain profits is the only way of providing the incentive for innovation so essential to capitalism.[41] Manne argues[42]

> "...even the most bureaucratically minded person may begin to have original ideas if the possibility of large rewards is apparent."

He argues that salaries and bonuses are appropriate forms of compensation for the pure management function, but that entrepreneurs require something 'much grander, though less certain'.[43] He draws the analogy with the patent system which is designed to '(1) exclude the would-be interloper; (2) provide the patentee with a substantial reward for his idea, although that reward will vary with the economic importance of the invention.'[44] For the person who has not founded his own business to exploit his idea, trading in the stock market on inside information provides a reward system.

This aspect of Manne's thesis is the most controversial.[45] It is difficult to imagine that corporations consciously consider rewarding employees by allowing them to trade on inside information. There are a number of specific criticisms that can be made.

First, the increased pace in the growth of new technology, coupled with the fact that corporations must innovate to survive, has meant that corporations have tended to manage innovation better, for example,

by paying people 'just to sit and think'. Thus, innovation, the mainspring of capitalism, is unlikely to dry up if insider trading is prevented.

Secondly, the insider has already been remunerated for his innovation through his salary. Therefore he has done nothing extra which is beneficial to the corporation or the economy to justify his obtaining further compensation by using his superior bargaining position in the marketplace.

Thirdly, even if it is conceded that the compensation is not sufficient, there is no guarantee that the insider is going to be able to take advantage of his innovation because of his own financial constraints and his limited perception of the corporation as a whole. As many of the sample of businessmen interviewed by the present writer pointed out, there are other more certain and more effective ways of rewarding the insider: for example, by employee bonus share schemes.

Fourthly, there are a number of situations that can be envisaged where the insider may be able to exploit inside information which are unrelated to any intrinsic merit on his part. For instance, where the information contains bad news, it is difficult to argue that the insider should be 'rewarded'. Even if the information is good, often its source will be extrinsic to the insider. For instance, foreknowledge that the dividend is to be increased is hardly capable of being described as an innovation, yet the insider may still be able to exploit that knowledge for personal gain on the securities' market.[46]

It is sometimes suggested that major shareholders who receive information through a 'nominee' director are entitled to trade on this information, on the basis that profits from such trading constitute a legitimate reward for the managerial expertise that they bring to

the corporation.[47] For the above reasons, it is suggested that their reward should lie in a management consultancy fee rather than in profits from insider trading on the securities market.

7. Is a major shareholder who trades on information received through a 'nominee' director subject to different considerations

To decide conclusively whether a shareholder who receives information through a nominee director is entitled to trade on that information, it is necessary to examine the status of the nominee director and the relationship of the shareholder with the corporation.

A director enjoys a special relationship with the corporation akin to a trust relationship, which is often termed 'fiduciary'.[48] As such he owes duties of loyalty and good faith to the corporation.[49] Unless the articles provide otherwise, the director will owe these duties regardless of how he came to be appointed.[51] Therefore information which he receives comes under the same umbrella of confidence as it does to other directors. The case where a person is a director of two competing companies shows that this must be so - for otherwise information concerning the other's activities could be passed by the director from one board to the other with impunity.[52]

Now, in some situations it may be advantageous for information to be passed on to the major shareholder: for instance if the corporation is seeking more finance, or if the corporation is supplying technology. However, in these situations it is as if the corporation is dealing directly with the major shareholder, so that the same conditions of confidentiality apply as in any other business deal. The shareholding of the major shareholder becomes an irrelevant factor. Therefore, trading by a major shareholder on information received through a 'nominee' director should be regarded in the same way as

trading by any other third party on information received while dealing with the corporation.

However, this view is not appropriate in all cases. Sometimes, where the shareholding is between twenty and fifty percent, and the equity participation is in the nature of a joint venture, it may be more appropriate to treat the shareholder as being on the board. Although the shareholder strictly does not owe the same fiduciary duties to the issuer as the directors, if it trades it should be subject to the same considerations as a director would be if he trades. Therefore, if an occasion arises when the board as a whole forbids the 'nominee' director from passing information on, and the director goes ahead and does so, the shareholder would be bound to treat it with the same degree of confidence as it treats other information. This is so, notwithstanding that the director is not acting on behalf of the issuer and could be more accurately described as being a tipper.[53] For practical purposes it is convenient to regard the major shareholder as sitting on the board of the issuer.

Two further points may be made concerning trading by major shareholders on information received through a representative or nominee director. It was argued by some of those interviewed that 'trading' on such information means buying and selling. Therefore it was argued that where the shareholder was only using the information to increase its shareholding, such as in a take-over situation, then that was not insider trading.

It is submitted that this argument should be rejected. As has been seen above, the argument against insider trading is not based predominantly on the concept of profits and losses. It is based on the use of information to which a confidence attaches for private benefit. Clearly, in the situation discussed above, the major shareholder is buying more shares because it

thinks that it will benefit. In conceptual terms there is little difference between an insider using information to make a gain by purchasing land, securities, or companies. The fact that the gain has not been immediately realised is beside the point. The profit has still been made.[54]

The second point to be made is that different considerations may attach where the shareholding by the major shareholder exceeds fifty percent. At this point, for equity accounting purposes at least,[55] the company becomes a subsidiary of the major shareholder. As such a much wider range of financial data becomes available to the major shareholder, and the major shareholder usually provides significant managerial, technical and logistical input. In such a situation, whilst in law the two companies are separate entities,[56] as a matter of practicality they are one. In such a case, the minority shareholders would expect there to be a free flow of information from one to the other, and, in the absence of fraud, it is unlikely that the courts would intervene.[57]

However, it is submitted that there is little difference in principle between a twenty and a fifty per cent shareholder. In both cases there will be likely to be significant benefits to both corporations in a free flow of information, especially where the major shareholder provides managerial and technological input. It is perhaps this factor which distinguishes the investor from the trader. The investor, though he may wish to vary his shareholding on occasions, has a long term commitment to the recipient corporation, which benefits all shareholders. The trader does not. Therefore, in any regulation of insider trading, some allowance must be made for major shareholdings which are in the nature of a 'joint venture', to allow them on occasion, after full consultation with the board of the recipient corporation, to vary their shareholding

(principally to increase it).

In principle then, it is suggested that where a major shareholder has built up a significant stake in a corporation and has reached the stage where it feels that it wishes to have a greater say in the running of the corporation by appointing a director, there is nothing wrong with that director passing information backwards and forwards from one board to the other. This flow of information is beneficial to both corporations - it improves the performance of the recipient and thus increases the value of the shareholder's investment. Two difficulties may arise however. One is where there is a conflict of interest. The other is when the shareholder wishes to change its shareholding. The first difficulty will be discussed later.[58]

With regard to the latter, on the basis of the requirements of efficiency, the shareholder must be able to change its shareholding. It cannot be 'locked in' in perpetuity. However, fairness requires that the shareholder should not be able to take advantage of information that it, by reason of its position, has access to, but which other investors and shareholders do not. Such an occasion would seem to demand a statement by the board of the recipient corporation, full disclosure by the major shareholder and trading at the going market price. Such would be a practical solution to a difficult problem.

Therefore, in principle, a 'nominee' director should not be prevented from passing information on to the major shareholder provided it is beneficial to the recipient corporation (or at least not detrimental) and the shareholder is in the nature of an investor or partner rather than a trader.

8. Tippees

A tippee is a person who receives price-sensitive inside information either from an insider or from another tippee. The question to be posed is whether the tippee should be permitted to trade on such information.

For the purposes of analysis, it is suggested that tippees can obtain inside information in two types of circumstance: one is when the tippee knows that the communicator of the information is an insider who is breaking a confidence in passing the information on; the other is when the tippee does not know. In the case of the second type of tippee, it is suggested that he cannot be labelled unethical or immoral if he trades on the information, unless perhaps it can be shown that he ought reasonably to have suspected who the source was and was under an obligation to make further inquiries. In such a case, he would be considered to be part of the first category above. Tippees who do not know or suspect that their immediate source was an insider must be free to trade. They do not owe a fiduciary duty to any individual or issuer. They are often unable to differentiate between fact and opinion, between facts that can be substantiated and rumours that can not. Furthermore, they, by trading, are providing an important source of information for the market. By trading on rumours, which are more often than not correct, they are increasing the efficiency of the market. Finally, rumours always abound in the market. People who trade on them are not normally regarded as acting unfairly. It is an accepted risk of the marketplace.

Moving on to consider the question of whether tippees who receive price-sensitive information knowingly from an insider source are subject to different considerations to those of insider traders, it is at once apparent that tippees will in most cases have no

relationship with the issuer either professionally or contractually. Therefore it becomes very difficult to establish the foundation on which to base a duty. The courts have consistently refused to admit that a tippee owes a fiduciary duty to the issuer.[59] It is difficult to see how a tippee owes a duty to the issuer at all. The tippee breaks no confidence, and deprives the company of no opportunity. Therefore, even if it is accepted that the confidence attaches to the information rather than the relationship, it is difficult to see how the company is disadvantaged, or indeed how some duty to the company can be established. Perhaps one such method would be if the tippee with knowledge was regarded as being in the same shoes as the insider, so that if he traded, he would be subject to the same considerations as the insider would have if he had traded. Whilst this has some initial appeal, it raises problems where the tippee has received the information second- or third -hand, or where the information is received in a different form from that which the insider had access to. The argument that one is unfairly using information obtained through one's special position for profit loses strength where the tippee is many times removed from the insider.

Perhaps the answer depends on what one takes to be the reference point when examining the problem. If one looks at it from the position of the tippee, it is difficult to imply anything more than that he was lucky to receive the information, the insider should not have been so silly or so careless as to give it to him, and that the remedy lies at the feet of the tipper rather than the tippee. This was the opinion of the majority of those surveyed, and for practical reasons more than any other, it is also the view of the present writer. However, if one takes the reference point as being that of other investors in the market, then it may be possible to imply some duty to the market.[60] Since these

other investors are still losing out to a person utilising inside information, and the tippee knows that the information is supposed to be confidential, these investors would feel that trading by the tippee was improper, and would have the same effect of lessening business confidence in the integrity of the market as would trading on the information by an insider. This latter argument would appear to be more persuasive if there was some arrangement between the insider and the tippee involving mutual back-scratching. However in this situation, the conduct would be improper from the position of the tippee also, because in such an arrangement he would be subject to condemnation as a <u>tipper</u>, nor as tippee.

The question of whether tippees with knowledge should be subject to the same considerations as insiders can probably not be answered conclusively in the abstract. It is a question of balancing competing principles. In practice too, there is no unanimity of thought. Some would see tippees as being subject to the same considerations as insiders, for "to immunise such third parties from liability would encourage insider 'leaks' to outside friends".[61] Others would see tippee information in the same way as other market information which is not generally known - something that one can trade on if one is lucky enough to find it. In the end, it must come down to balancing these competing views, and where the balance lies will depend on the degree of knowledge as to the source possessed by the tippee, and the strength of the relationship between the insider and the tippee.

D. <u>Conclusion</u>

Thus, insider trading, when examined in the light of the objectives of a securities market established earlier, appears to be generally detrimental - in theory, at least.

It breaks a confidence which is based either on the relationship between the insider and the corporation, or on the nature of the information as a property right *per se*.

It gives the insider a superior bargaining position for a reason that has no merit. It rewards superior access to information rather than superior analytical ability.

Though the damage caused to other investors in the securities market of a stock exchange transaction may be minimal and even unattributable to the insider, insider trading may cause damage to the reputation of both the corporation and the market. In this way it may undermine the flow of capital into the market in general and the stock of the insider in particular.

Profits from insider trading do *not* appear to be a legitimate reward for enterpreneurial activity for the principal reason that when one enters a corporation one expects to be rewarded for one's endeavours by the corporation itself, not extrinsically by the securities market.

Therefore, whilst Manne's thesis is attractively presented, it is suggested that it pays too little regard to the economic consequences of insider trading and extols a virtue which is non-existent. Perhaps the female law student had a healthier reaction to insider trading than her professor when she stamped her foot and declaimed 'I don't care; it's just not right.'[62]

This not to say that insider trading in all the situations contemplated should be outlawed. It has been seen that there are varying degrees of insider trading. At the narrowest level, where the insider is trading on a specific piece of information, the simplest way of deterring the insider is by ensuring early disclosure of the information to the market. This serves the dual purposes of

protecting the trust between corporation and insider, and ensuring that the market is functioning efficiently.

However, situations can be envisaged where it is impossible for the regulators to compel early disclosure. There may be information which is not in the corporation's interests to release immediately, or it may be of such a nature that it will never be formally released. In such a case there is a clear conflict between the objectives of preserving confidentiality and maintaining market efficiency. At this point it becomes a question of balancing an intangible quality such as trust or integrity against a more tangible quality, namely market efficiency. It cannot be a question of simply banning insider trading. Quite apart from the impact on market efficiency that this would have, as the information becomes more vague and less certain, the strength of the corporation's proprietary interest in the information, or the strength of the confidence extended by the corporation, begins to wane.

The strength of the confidence extended by the corporation may be weakened in other ways. As one moves further and further out from the control centre of the corporation, namely the board of directors, then the less one is likely to be held accountable to the coporation. A tippee is unlikely to be in a confidential relationship with the corporation. Neither is the office cleaner. Moreover, there is no clear dividing line between trading on an 'insider fact' and trading on a 'shrewd piece of analysis'.

These reasons suggest that as one moves away from the classical insider trading situation of a director trading on a specific and very price-sensitive piece of information, the importance of preserving a confidence as an objective declines relative to the objective of maintaining market efficiency. Therefore, a strong case may be made for allowing trading on information if the information can not be brought into the market in any other way. Perhaps it is at this point that the economist holds sway over the lawyer, the realist over the legal theorist.

Thus, two watershed points have been identified as one widens the circle of investors marked by the term 'corporate insider trader". The first is when no amount of regulation is going to produce more, or speedier, disclosure of information to the market. The second is when the requirement of market efficiency dictating that information be brought into the market so as to be reflected in securities prices, override the requirements of fairness and preservation of the confidence and integrity of management.

These two watershed points should be borne in mind when the objectives of a securities market are being implemented. Those objectives are well stated in the following:[63]

> "The ideal securities market should be a free and open market with the prices thereon based upon the fullest possible knowledge of all relevant facts among traders. Any factor which tends to destroy or put in question this concept lessens the confidence of the investing public in the market place and is, therefore, a matter of public concern."

V PRESENT REGULATION IN NEW ZEALAND

In analysing the extent of regulation of insider trading in New Zealand it is useful to have regard to the emphasis placed on the various methods available. Regulation is based on the twin mechanisms of disclosure and prohibition. These mechanisms may be applied by formal statutory controls such as a Securities Commission, or more informally by the use of professional-type bodies such as the Stock Exchange Association.

A. The Legislature

New Zealand is unique among its common law counterparts in that it does not have comprehensive, anti-insider trading legislation backed up by a statutory enforcement body.[64] Under the Companies Act 1955, directors are bound to register the particulars of any shares they hold in a company, including the price of any transaction that they may from time to time make, and the register must be kept available for inspection.[65] This may act as a mild deterrent in that directors who put value in the esteem with which they are held by others would be reluctant to put themselves in a position where they may be asked to explain their large volume of trading by their fellow directors. However, this provision is ineffective in that it only applies to directors, and that it is very easy to circumvent. For instance, it is relatively easy for a director to trade using a nominee to disguise his identity.

Therefore, the legislature, if indeed it has a policy against insider trading,[66] has left the regulation of insider trading to the courts, the Stock Exchange and other more informal bodies such as the Institute of Directors.

B. The Courts

1. The 'majority' rule

The courts have upheld a general obligation of loyalty owed by employees to their corporation. However, they have drawn a strong line between the duty owed by directors and the duty owed by other employees. Directors are under a

fiduciary obligation to act bona fide in the best interests of the corporation as a whole [67] to not put themselves in positions where their interests may conflict, to not make a 'secret profit' out of their position,[68] and to exercise skill and care in carrying out their duties.[69] Employees, however, in the absence of a contractual covenant, are not under a fiduciary obligation to refrain from using information which they receive as an employee for private advantage, provided they do not act to the detriment of the corporation. As such, because corporations can not purchase their own shares, employees would appear to be free at law to deal in their corporation's shares.

A director will be liable as a fiduciary to account to the corporation for any pecuniary advantage he makes as a result of his fiduciary position.[70] To be liable to account for profits, a fiduciary need not be in a position of conflict with his duty to the principal.[71] However, for the director to be held liable to hold the shares on trust for the corporation, it must be shown that he has deprived the corporation of its property, or of property that should have gone to it.[72] Since, as yet, a corporation cannot purchase its own shares in New Zealand,[73] directors cannot be said to be depriving the corporation of property. Therefore, the director will be liable to account to the corporation for profits only. However, if he deals in other securities such as land, which the corporation may also have an interest in, he may be liable as a constructive trustee.[74]

The impact of the fiduciary duty as a sanction against insider trading is, however, somewhat limited. For instance it provides no sanction against a director who deals on inside information to avoid a loss rather than to make a profit. A major practical problem with relying on the corporation to bring an action for recovery against the insider trader is that the persons in control of the

corporation will often be the same persons as those doing the insider trading. This is not so much a problem in large public corporations where shareholdings are more diverse and the board of directors is likely to be composed of outside, professional people. In such a case, because all share transactions come under the scrutiny of the board, the corporation would appear to be in the best position to detect insider trading and to do something about it.

However, in the case of closely-knit corporations where a major shareholder exercises strong control, particularly at board level, then the problem of corporate reluctance to bring an action for account remains. Alternatively, there seems nothing to stop the insider trader obtaining the company's consent to or ratification of his share dealings.[75] If this is done, in the absence of a constructive trusteeship there will be no liability to account for profits unless such consent or ratification can be shown to be a fraud on the minority.[76]

Reliance on the corporation for recovery of insider profits is unsatisfactory in other ways. It does not adequately compensate the shareholder for the loss he has suffered. As the insider profits recovered are an accretion to the funds of the corporation, each individual shareholder benefits indirectly in proportion to the number of shares he holds. However, a shareholder who sold to the insider will not benefit at all. Thus the majority rule is as not an effective or an equitable method of compensating shareholders who suffer loss at the hands of the insider.

Where no specific loss may be suffered by an individual shareholder, such as in an anonymous stock exchange transaction, then recovery by the corporation may be most appropriate in that it benefits all the shareholders rateably.

The courts' ability to allow individual shareholders to bring an action against insider traders has been hampered by the much-maligned Chancery decision of Percival v. Wright.[77] In that case, a director was approached by shareholders to purchase their shares at a quoted price. The director was aware of an impending takeover but did not disclose it to the shareholders. He accepted the shareholders' offer. It was argued that the defendants as directors were in a fiduciary position towards the plaintiff shareholders. On the facts of that case, it was argued that in negotiating the sale of the whole company, the directors had in law become trustees for the company and its shareholders, and could not purchase the interest of the ultimate beneficiary without making a full disclosure.

Swinfen Eady J. held that the directors were not under a duty to disclose the negotiations for the sale of the company. His Honour based his decision on the principle of incorporation. Under this principle, a shareholder knows that the directors are responsible for 'managing the business of the company in the ordinary course of management, and impliedly releases them from any obligation to disclose any information so acquired.'[78] His Honour stated that under this principle, a shareholder is fixed with knowledge of all the directors' powers, and has no more reason to assume that they are not negotiating a sale of the undertaking than to assume that they are not exercising any other power. Incorporation was held to not only affect the relations of the shareholders with the outside world, but also to affect their relations inter se. On this basis, Swinfen Eady J. held that the directors were not under a fiduciary obligation to the individual shareholders to disclose.

> "The contrary view would place directors in a most invidious position, as they could not buy or sell shares without disclosing negotiations, a premature disclosure of which might well be against the best interests of the company."[79]

However, perhaps most importantly, his Honour went on to say

> "There is no question of unfair dealing in this case. The directors did not approach the shareholders with the view of obtaining their shares. The shareholders approached the directors, and named the price at which they were desirous of selling."[80] (emphasis added).

This last part of Swinfen Eady J.'s judgment is important because it is commonly said that Percival v. Wright stands for the proposition that a director does not stand in a fiduciary relationship with individual shareholders, and consequently individual shareholders do not have standing to sue if the director uses inside information to trade in the corporation's shares.[81] However, as already pointed out, there was no question of unfair dealing, because the shareholders approached the directors. There was no unjust enrichment, because the negotiations for the takeover were abortive. This, it is submitted, is not to say that in no circumstances will a director owe a duty to individual shareholders.

2. Exceptions to the rule

There are at least two cases where the courts have held that there was a duty. In Allen v. Hyatt,[82] it was held that when directors purport to be acting on behalf of individual shareholders, an agency is formed and the directors became accountable to the shareholders *qua* agents, not *qua* directors. Viscount Haldane who delivered the opinion of the board said[83]

> "The appellants appeared to have been under the impression that the directors of a company were entitled in all circumstances to act as though they owed no duty to individual shareholders. No doubt the duty of the directors was primarily one to the company itself. It might be that in circumstances such as those in Percival v. Wright they could deal at arm's

> length with a shareholder. But the facts in the present case were widely different from those in Percival v. Wright, and their Lordships thought that the directors must here be taken to have held themselves out to the individual shareholders as acting for them on the same footing as they were acting for the company itself, that was as agents...". (emphasis added).

Implicit in this passage are at least two propositions. First, that although a director may owe a duty primarily to the company, he may also owe a duty to individual shareholders. Secondly, although there may be circumstances such as those in Percival where a director may deal at arm's length with a shareholder, there will be circumstances where he may not. Examples of such circumstances may be when the director approaches the shareholders, or when the director could release the information if he wished to, because its release would do no harm to the company, but instead he trades on it.

The second case, which provides another example of an instance where a director may owe a fiduciary duty to individual shareholders, and which lends further weight to the proposition that the decision in Percival v. Wright must be confined very much to its facts, is the New Zealand decision of Coleman v. Myers.[84] Once again, the facts are important in terms of the decision reached.[85]

The case involved an offer by two minority shareholders, who were also managing director and chairman, of an old, established family firm, for the remainder of the shares in the company. The offer was made by another company which the two shareholders held all the shares in. Most of the shares in the family company were held by relatives or family trusts. The offerors failed to disclose that the market value of the assets of the company was much in excess of the

valuation given them by their share offer. The offerors were aware of this because of their positions on the board of the family company. The offer was accepted. Subsequently the offerors sold off some of the assets of the company (principally land) to pay for the shares. When they learned of this, some of the offerees brought an action claiming fraud, breach of fiduciary duty, and negligence.

Mahon J., after a discussion of Percival v. Wright and the developments since, said[86]

> "...I reach the unhesitating conclusion that the decision in Percival v. Wright, directly opposed as it is to prevailing notions of correct commercial practice, and being in my view wrongly decided, ought no longer to be followed in an impeached transaction where a director dealt with identified shareholders."

> "...The essential basis of breach of fiduciary duty is the improper advantage taken by the defendant of a confidence reposed in him either by, or for the benefit of the plaintiff. When one considers the legal relationship between the shareholder in a limited liability company and the directors entrusted with the management of the company, it appears to me that in any transaction involving a sale of shares between director and shareholder, the director is the repository of confidence and trust necessarily vested in him by the shareholder, or by his legal status, in relation to the existence of information affecting the true value of those shares."[87] (emphasis added).

Woodhouse J. in the Court of Appeal qualified this by holding that the standard of conduct required will differ:[88]

> "...depending upon all the surrounding circumstances and the nature of the responsibility which in a real and practical sense the director has assumed towards the share holder."

Mahon J. seems to contemplate a fiduciary duty occurring only when the director is dealing with identified shareholders. This would seem to exclude stock exchange transactions. In view of Woodhouse J.'s comments on appeal (Cooke J. make similar comments)[89] it would seem that a director will only owe a fiduciary duty to individual shareholders when he is in a 'special' relationship. Whether such a 'special' relationship occurs will depend on the facts. However, it seems clear that the Court of Appeal did not contemplate a general duty on the part of directors to refrain from deriving a personal advantage from their dealing with other shareholders.

In summary then, the courts appear willing to allow corporations to recover from insider traders, but unwilling to allow individual shareholders to recover. This stems from their support of the notion that the company is a separate legal entity which employs directors and to which the directors owe a fiduciary duty. The legal fiction that a company is distinct from its incorporators is extended so as to exclude a duty on the part of directors (or other insiders) to the individual shareholders. Swinfen Eady J. used a version of this rule when he refused to recognise a duty by directors to shareholders on the basis that shareholders must be taken to know that when a director is given responsibility for management he will come into possession of price-sensitive information which, if released, may be detrimental to the company as a whole (the 'internal management' rule). As a director's first duty is to the company as a whole, the shareholder would not expect him to release such price-sensitive information. This preoccupation with the concept of the company as a separate legal personality prevents the courts playing a leading role in the regulation of insider trading. This is especially so where the trading takes place on the stock exchange, or when the insider trader is not a director, or when the person who deals with the insider is not a shareholder at the time of the transaction.

C. Self-Regulation

Probably the strongest and most effective method of regulating insider trading in New Zealand at present is the self-regulatory method. This comes in semiformal form in the practice guidelines and listing requirements of the Stock Exchange Association,[90] and in less formal form in the surveillance by boards of directors of share transactions in their respective companies.

1. Self-regulation:directors

The Stock Exchange Association is the primary regulatory body in the stock market in New Zealand. Its ambit of control is limited to publicly-listed companies. It seeks to promote full disclosure of information by companies through its listing requirements. One requirement provides[91]

> "501. The company has agreed to supply promptly to the Exchange all relevant information (within the Company's knowledge and power to release) so as to ensure that the market is at all times properly informed."

Thus there is a general duty on the company to ensure that the market is kept informed.

In addition, companies must provide the Stock Exchange with yearly and half-yearly accounts[92] which provide more detailed financial data.

Similarly, under the Takeover Code,

> "604. No material information is to be withheld by either offeror or offeree and all material information made available to any one shareholder in his capacity as shareholder, is to be made available to all. In the case of a listed company, the Exchange is also to be advised.

> 605. A false or uninformed market must not be allowed to develop by the offeror or offeree company in the shares of either. The Exchange must be notified of any talks or negotiations involving a listed company immediately it can reasonably be inferred that an offer may result."

In addition, directors are probited from passing on price-sensitive information to third parties:

> "603. Directors are not to pass to third parties information that, if acted upon, might enable such third parties or others to deal in the market to their advantage."

Directors are prohibited from trading in the shares of the offeror or offeree companies until the market has been informed of the offer. When they do trade, they must inform the Stock Exchange that they have traded, and must state the details of volume and price.[93]

These requirements do not appear in the main body of the Manual relating to ordinary announcements. Therefore there is no express control of directors' dealings in situations other than the take-over situation. The listing requirements, other than in the take-over situation, only regulate insider trading by means of the disclosure mechanism.

If a company fails to comply with the listing requirements there is provision for trading in the company's shares to be suspended pending a full inquiry, or even, in an extreme case, for the company to be delisted.

Whilst there is provision for disclosure and the possibility of sanction, it is unclear exactly what is contemplated by 'false or uninformed market' and 'material information'. Paragraphs 501 to 512 cover price-sensitive items such as dividends, profit announcements, half-yearly reports, offers for shares and the like. Paragraph 513 provides that the Executive Director may be consulted on a confidential basis, but this is only helpful when the company is willing to disclose information in the first place. It is suggested that only in the most blatant of cases, where the information is very price-sensitive, will the breach be detected and corrective action be taken. However, that is not to say that the Listing Manual provisions are ineffective. The threat of some action being taken by the Stock Exchange would normally be enough for a director, mindful of the best interests of the shareholders, to take action to ensure that continued trading in the shares of the company is not endangered. It might be argued that on this basis, directors will disclose more rather than less, to be on the safe side. However, given the present, what many would consider to be woeful, lack of disclosure of information by public companies in New Zealand, it is difficult to find support for this hypothesis in practice.

Where perhaps the Stock Exchange Association is becoming more successful is in the release of more general financial information in the Annual Reports. For instance, from 1983 onwards, accounts calculated according to Current Cost Accounting principles must accompany the ordinary accounts. In this way, a greater body of information is made available, and the opportunities for insider trading are reduced.

In an effort to establish proper standards of conduct and to discourage insider trading, the Stock

Exchange Association has issued "Stock Exchange Guidelines for Securities Transactions by Directors of Companies".[94] These Guidelines were prepared with the informal assistance of the Institute of Directors. They establish a series of basic principles of good practice and then set out some model rules based on these principles.

In brief, the principles are as follows:

(1) directors should not deal in their companies' securities on considerations of a short-term nature

(2) directors must accept that they are not free at all times to deal in their companies' securities

(3) directors should accordingly not deal immediately prior to regularly recurring information (eg profit) announcements. Nor should they deal prior to announcements of an exceptional nature which may affect the market price

(4) what constitutes an eceptional announcement involves an element of judgment, but examples are those contained in paragraphs 501-503 of the Listing Manual.

(5) the prohibited period prior to an exceptional announcement should start from the point at which the likelihood of an announcement ultimately being necessary becomes a reasonable possibility.

In brief, the rules are as follows:

(1) A director who receives inside information by virtue of his position, should not use that information to deal in his or any other company's securities.

(2) A director may otherwise feel free to deal if he
   a) notifies the chairman of the board and receives acknowledgement
   b) obtains a written record of the above
   c) does not trade within two months of company results announcements unless in exceptional

circumstances such as a pressing financial commitment.

d) in the case of a take-over offer, waits until the market has been informed of the offer.

(3) A register of directors dealings should be maintained, and available for inspection.

(4) The directors should ensure that employees also deal in accordance with the guidelines.

These guidelines are a useful statement of what constitutes good conduct. They do not, however, seem to cover the case of tippee trading. Nor do they seem to cover the case where a representative director passes information on to a major shareholder and the latter uses the information to trade.

As they are recommendatory in nature only, the guidelines lack any formal sanction. They are more a statement of what is thought to be proper conduct, possibly increasing the pre-existing unwritten standard. By putting the standard into writing, the guidelines aim to increase the general standard of conduct. A further aim is that the guidelines will be used by directors in formulating and interpreting their own company codes.[95]

The guidelines set out a business ethic. Business ethics provide a powerful check on the behaviour of most professional people. As many directors are professional people, notably lawyers and accountants, many of the standards they are subject to in their own professions are brought over into their directorships. As such, the standard of ethical behaviour expected by directors of themselves and of others is very high. As one of the interviewees remarked,

> "The standard which I would apply in my personal affairs may be higher than I would require of others".

The writer was impressed with the general standard of conduct which the interviewees observed in their everyday affairs. Most felt bound to purchase 'a sizeable parcel' and to 'stick by it'. Clearly, 'wheeling and dealing' was very much frowned on, as was a 'loose tongue'. It was the general concensus of opinion that many directors were concerned to be seen to 'do the right thing'.

The presence of written guidelines could be seen to have an effect in two ways. First, some 'law-abiding' individuals will respect the guidelines. Others will be influenced by these people and will follow their lead. Secondly, some will be deterred from breaching the guidelines by fear that others will disapprove. In this way, the vast majority of directors of public corporations are effectively kept in line.

One final check is that a register of all directors shareholdings and dealings must be kept by the company and available for public inspection.[96] Directors' shareholdings must now be published in the annual reports.[97] Thus, unless the director trades under a nominee, he will be the subject of scrutiny by his fellow directors and the shareholders.

2. Regulation of employees

As regards trading by other insiders such as employees, there are two major constraints. The most obvious is that lower level employees are not going to have the same degree of access to price-sensitive information as directors. Nor are they likely to have a complete picture of the corporation to enable them to see the price effect of their snippet of information.

Secondly, the directors exercise a real degree of control. Unless an employee trades in the name of a nominee, his name will appear on the share register

which is the subject of regular inspection by any conscientious board. Therefore any short-term trading can be detected and the employee summoned to explain. At least three of those interviewed expressly stated that if they discovered that any of their employees had indulged in insider trading, they would dismiss them forthwith.

In the case of employees of accountancy firms who may be privy to information contained in the accounts of a company they audit, they are often required to sign a secrecy agreement. Therefore, if they breach this agreement by insider trading, they are also liable to instant dismissal and may be liable to damages for breach of contract.

Therefore employees are discouraged from insider trading by the prospect of dismissal from their jobs. The directors or senior management act as an enforcement body.

3. Other factors - smallness of market

The size of the New Zealand share market is very small in relation to markets overseas. The market is also compact. This means that there is much greater awareness about what everyone is doing than there is in the United States where there are thousands of listed companies and thousands of miles between markets. The New Zealand corporate scene is characterised by interlocking directorships. This makes it very difficult for the insider to trade undetected, or to trade without a question-mark hanging over his motive for transacting. This closeness, combined with the high ethical standard expected as outlined above, acts as a powerful, informal, regulatory tool.

D. The Position of Shareholders who receive Information through a 'Representative' Director - are they regulated?

There is no legislative control of nominee or representative directors other than the sparse requirements of registration of directors' shareholdings outlined earlier and the remedies provided in the case of oppression of minorities.[98]

There is however, a little more judicial control. Lord Denning in Scottish Co-operative Wholesale Society v. Meyer[99] stated that where a person was a director of two companies, and found himself in a position of conflict, he would be failing in his duty to one if he subordinated its interests to those of the other. The relevant facts were that three directors (out of twelve) of the co-operative society were also directors of a textile company which the society held a majority of the issued shares of. The textile company had five directors in total, of which three were appointed under the articles as 'nominees' of the society.

Lord Denning said:[100]

> "So long as the interests of all concerned were in harmony, there was no difficulty. The nominee directors could do their duty to both companies without embarrassment. But, so soon as the interests of the two companies were in conflict, the nominee directors were placed in an impossible position. It is plain that, in the circumstances, these three gentlemen could not do their duty by both companies, and they did not do so.
>
> ...They probably thought that 'as nominees' of the co-operative society their first duty was to the co-operative society. In this they were wrong. By subordinating the interests of the textile company to those of the co-operative society, they conducted the affairs of the textile company in a manner oppressive

to the other shareholders."

These are clear dicta that although it is possible to be a director on two boards, acting as a nominee on one, the director must ensure that in the case of a conflict situation arising, he separates his duties to the respective companies, and does not subordinate one to the other. Lord Denning sees the director in the conflict situation to be in an 'impossible' position. Therefore it may well be that a director, when faced with a conflict situation, must either resign from one board, or deprive himself of access to all information which may be detrimental to one company if it is released to the other. If he chooses to continue to play a full part in the affairs of both companies, he must be very careful to separate their affairs.

The extent of the 'conflict' situation as envisaged by Lord Denning is unclear. Obviously it would cover the case where the two companies are competing: for example a takeover situation. However, a conflict may be thought to arise where the director of the 'subsidiary' company learns of bad news. If he passes this information on to the principal company, the latter may be encouraged to sell out, or lessen its commitment. It is submitted that this is not a 'conflict' situation. If the principal company does trade on the bad information, it is subject to the same regime as any other insider trader. But the assumption was made earlier that the principal company was not using the information it received through a nominee director to trade. Rather, it was being used to assist both companies.

Lord Denning suggests that in the case before him the 'nominee' directors of the society were acting in a 'manner oppressive to the other shareholders'. As such, the other minority shareholders may apply to the court for relief.[101] If it appears 'just and equitable' to do so, the court may make an order regulating the conduct of the company's affairs in future, directing the company to institute or discontinue court proceedings and restricting

or forbidding the carrying out of any proposed act.[102] In extreme cases where the directors have acted in their own interests, rather than in the interests of the company as a whole, in a manner that appears to the court to be unfair or unjust to any member of the company, the company may be wound up by the court.[103]

The dictum quoted above of Lord Denning - "so long as the interests of all concerned were in harmony, there was no difficulty" - suggests that his Lordship contemplated a close relationship between the company and the major shareholder, with information passing from one to the other. However, his Lordship was contemplating a case which is not typical in two respects. First, the 'nominee' directors were appointed pursuant to a provision in the articles, which specifically contemplated 'nominee' directors. Usually there is no such provision, and the major shareholder merely exercises its numerical voting strength in a general meeting to appoint its 'nominee' directors. Opinions differ as to whether such a 'nominee' director is under different obligations to those of a 'nominee' director appointed pursuant to the articles.[104] It is said that in the absence of specific provision in the articles, a director appointed by a major shareholder owes the same duties as any other director. The present writer agrees with this. However it does not follow that in passing on information to a major shareholder, a 'nominee' director is breaching his duty to the company. Provided the giving of such information is beneficial to the company, it is submitted that the director is acting in accordance with his duty. It is submitted that the alternative proposition that information should not be passed on would have the unfortunate result of making a distinction between a human being who is a major shareholder, who could become a director and be privy to information, and a company who is a major shareholder, who cannot become a director except through one of its officers, and who could not be privy to information. Where the nominee director is the managing director of the major shareholder the distinction becomes

unworkable. It is suggested that having a provision in the articles stating that certain directors are 'nominee' directors merely makes explicit what was implicit, namely that information is expected to be passed backwards and forwards between the boards of the recipient company and the major shareholder. It is noted that the opportunity always exists for the board of the recipient company to put a restrictive caveat on any information it does not want passed on, or alternatively, the director may be asked to leave the room.[105]

Secondly, the Scottish Co-op case is different in that the society had a majority of the issued shares. Typically, in New Zealand, the stake may be as low as twenty per cent, yet the shareholder may have sufficient control to appoint a director. It is sometimes said that there is a difference in principle between such a shareholder and one who has over fifty per cent. This is on the basis that when a shareholding reaches fifty per cent, the company becomes a subsidiary, and thus becomes subject to different considerations. For instance, financial data must become available for equity accounting purposes. However, it is submitted that in principle there is no difference. In law, the two companies are still regarded as separate entities,[106] and the minority shareholders are still entitled to freedom from oppression. These rights are the same whether the major shareholder in control is in a minority or a majority position. Furthermore, the directors still owe a fiduciary duty to the company to act bona fide in its best interests, whatever the shareholding of the major shareholder. In practice, the minor shareholders will normally have the choice of accepting that the major shareholders will have a major influence on the company's policy, or selling their shares and getting out.

Since there is a divergence of opinion as to what constitutes proper commercial practice in regard to the passing on of information by nominee directors, the informal

controls which apply to insider trading are not as strong in this field. There is also some ambiguity as to the distinction between someone who 'buys and sells' on inside information and someone who just 'buys'. It would be fair to say that the majority would feel that shareholders who receive information through a 'nominee' director should not trade except in exceptional circumstances; but this does not act as much of a sanction.

E. Effectiveness of Present Regulation of Insider Trading in New Zealand

The dual regulatory mechanisms of the courts, and ethical standards, act in a complementary manner. The courts will act to prevent insiders (principally directors) abusing their position by trading on inside information, if it can be shown that there was a special, confidential relationship between the parties. This will only occur in a face to face dealing. Thus it would be likely to occur only in smaller private companies. Alternatively, where the director acts in a manner oppressive to minority shareholders, the court may give relief under the power given in the Companies Act 1955.

On the other hand, in the case of larger, public companies where transactions are carried out through intermediaries on the stock exchange, the dual controls relied on are those of business and professional ethics playing on those at the top, and those at the top in turn controlling those below.

Perhaps the strength of this 'ethical' control lies in the fact that it is not too specific, and until recently, largely unwritten. Since concern with reputation is such a strong motivating factor in professional life, seeking to 'do the right thing' produces conservative conduct among the vast majority of directors.

There are gaps however, in the present regulatory set-up. First, as can be seen from the attitude of the

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Court of Appeal in Coleman v. Myers,[107] the courts will not find a fiduciary duty to individual shareholders based solely on the relationship of director and shareholder. What constitutes the something extra to make the relationship fiduciary is unclear. Secondly, although the courts have upheld a fiduciary duty between the director and the company, and have therefore held that a director may not make a secret profit out of his position, the problem remains of getting the company to bring an action. This is especially so where the director is also a controlling shareholder. The situation has been helped somewhat by recent statutory changes which allow a shareholder to apply to the court to make an order directing the company to institute proceedings.[108]

Thirdly, the general problem remains of detection of insider trading, especially in non-listed companies. It may be argued, in the case of face to face dealings, such as usually occur in a private company, that the other party must know that the insider is going to be in possession of more information, possibly of a price-sensitive nature and takes that risk when he trades with the insider. He always has the option to request disclosure. If the director misrepresents the position, then the courts are likely to find the special relationship requirement is fulfilled. Otherwise it is a case of caveat emptor just as if the insider was selling a motor vehicle.

In the case of stock market transactions, the problem of detection is exacerbated by the availability of nominees which allowsinsiders to trade anonymously. The problem of nominees is one that arises in relation to the whole market, not just in the area of insider trading. Therefore its remedy lies in wider considerations than the regulation of insider trading.[108A] If the nominee problem is eliminated then detection of insider trading does not present such a difficult problem. Turnover in shares is relatively low in New Zealand. This enables directors to keep a check on who is buying or selling. The directors'

share register provides a further check. If directors are worried about their reputation they are likely to be deterred from placing themselves in a position where they may be required by the board to explain their motives for trading.

Fourthly, whilst there is no doubt that the situation is improving, there is still a general lack of disclosure of information by companies in New Zealand. This is particularly so with respect to information which is of a one-off rather than ongoing nature. The market seems not to respect frank discussion. Therefore when a company is doing well its performance is underplayed in the company report and when it is doing badly its performance is over-played. There is no immediate remedy to this problem. Investors must resort to market analysts to obtain a true picture. Thus, the present regulatory set-up has deficiencies in terms of encouraging a full, fast and frank disclosure of information to the market. In this way it is not meeting the requirements of efficiency and equity.

Fifthly, whilst the informal sanctions of business and professional ethics work very well in the majority of cases, in a small number of cases, particularly in the 'nominee' director field where the requisite standard of conduct is not settled, these sanctions break down. As the sanctions are informal, there is little that can be done to deter a person who is willing to incur the wrath of his colleagues and who has a sufficient power base to withstand any putdowns that may come his way; for example refusal by others to appoint as a director in other companies.

There is also very little regulation of insiders within the wider circle of insiders such as junior officers and tippees. The example of accountancy firm employees who must sign secrecy agreements was cited to show how some of these insiders are controlled. But as a practical matter, even if the board discovers active trading by an employee and suspects that use has been made of inside

information, it would be very difficult to prove that the employee actually used the information. A possible check on these types of insiders is that they will not be privy to the whole picture and thus are often as not likely to get it wrong and lose money by trading.

Tippee trading, it seems, goes unchecked by law,[109] or by ethics. Most of those interviewed did not recognise any duty not to trade on tippee information. The remedy was seen as lying against the tipper - the director - for disclosing information which he should not have. This suggests that it is not wrongful for a tippee to make a profit by trading on information which is price-sensitive and not generally available. The tippee has abused no position of trust. However, his conduct is wrongful under the broader rationale that persons with special knowledge derived from a privileged position should not be able to use that knowledge to the direct detriment of members of the general public.[110] Independent of which view is correct, tippee trading is ordinarily not the subject of regulation in New Zealand at present.[111]

VI ALTERNATIVE METHODS OF REGULATION

As mentioned earlier, virtually every other common law country has comprehensive anti-insider trading legislation backed up by a statutory enforcement body. These, and the other regulatory methods used will now be examined with a view to determining how effective they are in achieving the goals of the regulation of a securities market as established in the earlier part of this paper, at what cost these objectives are achieved, and how applicable these methods are to New Zealand.

When examining the various regulatory possibilities it is useful to have in mind some of the parameters. Some of the structural parameters are: who is an insider? when must he report? when does liability arise? how may liability be enforced? how may liability be measured? what defences to liability are there?

VII UNITED STATES

The regulation of the securities market in general, and insider trading in particular, in the United States is the most comprehensive and most established of all common law countries. The regulation takes the primary form of legislative and common law sanctions, and comprehensive disclosure requirements. On a secondary level are the informal regulatory measures of the New York Stock Exchange and the interplay of business ethics.

Regulation of insider trading began with the enactment of the Securities Exchange Act 1934 (the 'Act') in the wake of the Wall Street stock market collapses. This Act provided for fuller disclosure of information,[112] introduced the 'short-saving profits' rule'[113] and set up an administrative and regulatory body, the Securities and Exchange Commission (S.E.C.). The SEC was set up with semi-legislative powers to supervise and regulate the securities market.

A. Disclosure

Under section 16(a) of the Act, every director,[114] senior officer of a company with a registered equity security,[115] and all persons who are directly or indirectly the beneficial owner of more than ten per cent of any class of equity security, come within the general class of insiders who must make disclosures.[116] These insiders are under an initial obligation to make a statement of their shareholding in the corporation and an ongoing obligation to report all changes in their beneficial ownership to the SEC within ten days. These reports are then published monthly. In this way it can be seen whether insiders are trading or not - the first step in the detection of insider trading. It also has a deterrent effect in that some of these insiders will be discouraged from trading by the prospect of their revelation by publication.

This section, along with the other disclosure provisions in the Act, has meant that there has been a

substantial expansion in the amount of information available. It may be said that a major achievement of the SEC has been the expansion of regulations for the gathering, preparation and dissemination of material disclosures concerning public companies so as to enable the formulation of an informed analysis of the value of the securities of publicly-listed companies. This great expansion in the amount of information available has fostered the professions of market analysts, investment advisors and the like who, on the basis of the information required to be disclosed, make judgments as the value of securities. It has been estimated that there are now over 14000 analysts. This has meant that security prices react quickly to reflect a broad set of information.[117] But it has also meant that there is just too much information available for individual private investors to absorb themselves. It leads one to seriously question whether the proliferation of vast amounts of data is really going to equalise the bargaining positions of individual investors who do not have the analytical skills to transform that information into a meaningful investment judgment. This raises the question whether the disclosure must be made in a 'digestible' form. From the standpoints of both market equity and market efficiency it is suggested that it must be.[118]

One of the problems of the disclosure provisions of the Securities Exchange Act is that because they require the financial and other reports with respect to earnings, assets and other material information to be filed only at the close of particular periods and permit these reports to be made a considerable time after the close of such periods, the information contained in these reports always lags behind significant new information which has developed in the interim. Thus, the essential requirement for disclosure of information of a short-term nature, namely speed, is missing from the provisions of the Act. As a consequence, gaps may exist in the reporting of developments which may affect transactions in,and values of,securities on the exchange.[119]

In response to this the New York Stock Exchange and others have included specific provisions relating to prompt disclosures of important types of information in their listing requirements.

B. Legislation

The most significant direct prohibition of insider trading by the Legislature is contained in section 16(b) of the Act. This provides for corporate recovery of 'short-swing' profits from insiders in companies registered under section 12 of the Act. Insiders here are the same as those required to file reports under section 16(a). The effect of the section is that all profits made by someone within the relatively narrow class of insiders, where the trading (buying and selling or vice versa) has taken place within a period of six months, can be recovered by the company. The action may be brought by the issuer of the relevant securities or by a shareholder on behalf of the company. The liability is imposed irrespective of whether the trader actually traded on inside information or not. The trading period of less than six months is arbitrary and fixed. If the insider trades on inside information with a period of six months and one day separating the buying and selling, then he will not be required to disgorge his profits under section 16(b). The rationale behind the 'short-swing profits' rule is that most inside trading occurs on considerations of a short-term nature, that detection of insider trading, especially in stock exchange transactions, is very difficult and even if defected, there are difficult problems of proof, so that the best way to prevent insider trading is to take the profit out of all trading by insiders when they trade in the short-term.

The rule may be criticised on a number of grounds. First, the definition of insider used is narrow. It does not include all those who owe a fiduciary duty to the company such as professional advisors. Nor does it include insiders of one company who use inside information to buy shares in another company. Secondly, it takes no account of the

motives of the insider for dealing. The innocent are caught to prevent the guilty going free. The validity of this approach would depend on one's view of the seriousness of the insider trading problem, but it is suggested that the problem would have to be very serious to warrant such a measure. Thirdly, the insider is only made to account for any profit he makes. If he does not realise the profit within six months, or market conditions change to cancel out his gain, then nothing is recoverable. On this basis it seems that the insider will not lose if he trades and 'takes his chances'. If this is true, then the provision is not fulfilling its purpose of stopping insider trading. Fourthly, the rule does not provide any direct benefit to the individual shareholder who traded with the insider. Therefore, there is no real incentive for a shareholder to bring an action.

In practice the rule has been superceded by other anti-insider trading measures which will be discussed below. The rule has not been followed in any other country. It arose out of the Wall Street collapses when corruption in the market place was felt to be rampant and strong measures were seen to be needed. It may not be appropriate to the quieter and more sophisticated market of today.

C. <u>SEC Control and Civil Liability</u>

The SEC has developed a number of rules under its regulation-making power. The most important rule relating to insider trading is Rule 10 b-5.[120] The Rule says

> "It shall be unlawful for any person, directly or indirectly, by use of any means of instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange
> (1) to employ any device, scheme, or artifice to defraud,
> (2) to make any untrue statement of a material fact or to <u>omit to state a material fact</u> necessary

in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." (emphasis added)

Although it was not originally designed to deal with the insider trading problem, Rule 10 b-5 is now the major source of civil liability to other shareholders.

D. Common Law Liability to the other Party

For a period after the Act was passed, the courts restricted the scope of the director's duty to a fiduciary duty owed to the company. If he used information received as a result of his insider capacity for personal profit, he was obliged to disgorge his gains to the company.[121] (The so-called 'majority' rule). A number of exceptions had become accepted where a special relationship could be said to exist between the director of a corporation and an individual stockholder so that the individual could bring an action in his own right.[122] (The 'special circumstances' rule). In some States, the courts have upheld a general duty owed by directors to individual shareholders.[123] However, no court has upheld a duty to disclose information when the transaction is on the stock exchange. In addition, only existing shareholders who sell to insiders are protected.

E. Extension of Civil Liability under Rule 10 b-5 - how the law has developed

The Rule was found to give rise to a private right of action; the disregard of the command of a statute was seen as a wrongful act and a tort.[124] Progressively the rule has been extended to face-to-face dealings[125] and to stock exchange transactions.[126]

1. Who is an insider

The rule does not use the word 'insider'. Instead it uses 'any person'. This has been held to extend beyond the definition provided in section 16 of officers, directors and major shareholders to include brokers, geologists, electrical engineers, attorneys and tippees.[127] The obligation to disclose rests on two principal elements:[128]

> "[F]irst, the existence of a relationship giving access, directly or indirectly, to information intended to be available only for a corporate purpose and not for the personal benefit of anyone and second, the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing."

In the case of tippees, it is unclear whether the liability is 'strict' or whether the tippee must have acted with actual or constructive knowledge that the material information was undisclosed. It has been suggested that a tippee having inside information has a duty to the general public rather than a fiduciary duty to the company (as the tipper has).[129] On this basis his means of obtaining the inside information is irrelevant provided it can be shown that he knew or should have known that his source of information was the company. If this is accepted, it would considerably widen the class of insiders caught by the rule.

2. When does liability arise

However up until very recently, the application of rule 10 b-5 has been restricted solely to the use by insiders of material undisclosed corporate information relating to their own company and its shareholders.[130] Moreover, the duty to disclose (or abstain) arises only where there is a specific fiduciary or confidential relationship derived from such common law concepts as

trusteeship or agency, between the specific purchaser and the specific seller of the securities. In the recent case of Chiarella v. United States,[131] Chiarella was employed by a financial printer regularly engaged in the printing of literature with respect to proposed tender offers. The literature, when submitted to printers, usually used code names to hide the identity of the offeror and offeree. Chiarella guessed the names of the companies and, without public disclosure of his conclusions, purchased the securities of several tender companies. Later, after the ender offers were publicly announced, he sold the securities at an aggregate profit of approximately $30000. The majority of the Supreme Court upheld the above conclusion that a duty to disclose or abstain from trading arises only where there is a special confidential or fiduciary relationship. However, the court did not decide the question whether rule 10 b-5 is violated when the conduct alleged constitutes a fraud upon the clients of the trader's employer but when no duty is owed to those with whom the trader deals. In a subsequent case it was held that such conduct does constitute a breach of those fiduciary duties.[132] It was then held that the rule was satisfied because it was a "fraud in connection with the purchase or sale of any security."[133] So it may now be said that providing the insider breaches his fiduciary duty to his own company, he is liable under rule 10 6-5 if he trades in the securities of another company.[134] This, it is submitted, in effect does away with the constraints of having to show some kind of special or fiduciary relationship.

The SEC has responded to Chiarella by adopting rule 14 e-3, made under section 14(e) of the Act. The rule prohibits trading while in possession of material nonpublic information relating to a tender offer. The exact ambit of this rule is unclear and must await further judicial consideration, but it illustrates the strength of control which the SEC exercises over the securities market.

3. What is material information

It has been said that rule 10 b-5 is [135]

> "...based on the justifiable expectation of the securities market place that all investors trading on impersonal exchanges have relatively equal access to material information."

It is clear that mere familiarity with the corporation's operations or information resulting from superior personal powers of analysis, do not require disclosure under the rule. Nor does trading on market rumours, provided that the outsider is without specific information that the rumour is derived from the company itself or other inside sources and without reason to believe that the rumoured information is confidential in any way.[136] However these cases where investors, who are in a better position than the rest of the market, are allowed to trade, probably constitute exceptions to the general rule. The SEC and the courts have developed relatively strict tests to decide whether a disclose or abstain duty should be imposed. For instance, the Supreme Court in Texas Gulf Sulphur rejected the test of the Court of Appeals below that the information must be "reasonably certain to have a substantial effect on the market price" and held that the correct test was that "which in reasonable and objective contemplation might affect the value of the corporation's stock or securities".[137] However, the overall effect of recent authorities has been said to indicate that information must be [138]

> "factual, correct, specific and material, must have a high probability of occurrence, and must be of such a nature that if disclosed, it would have a significant effect upon prices."

Whilst the courts have not defined what constitutes material information with any particularity, the New York Stock Exchange has provided the following definition:[139]

> "Negotiations related to acquisitions and

> mergers, stock splits, the making of arrangements preparatory to an exchange or tender offer, changes in dividend rates or earnings, calls for redemption, new contracts, procedures or discoveries."

F. Analysis of Provisions

The courts have developed a reasonably comprehensive definition of 'insider'. Therefore on the face of it, it appears that the United States system of regulation very much favours the principle of disclose or abstain to the exclusion of market efficiency. This description is backed up by the willingness of the courts to relax the formal requirements of reliance, causation, privity and subjective intention. It appears that the all-embracing concern of the SEC and the courts is to stamp out insider trading. The law has developed in a somewhat piecemeal fashion with uncertainty and inconsistency in the various court decisions as to the elements necessary for liability. One of the effects of this has been that flexibility has been maintained, which has discouraged the dishonest from inventing ways to get around the provisions. One other deterrent is the prospect of criminal prosecution under section 32(a) of the Act. Whilst this has been used sparingly, it may have had a deterrent effect. The preference has been to rely on civil actions with their lower standard of proof.

In summary, the expansive disclosure provisions have provided a feast of information, not always in a digestible form. The reporting requirements have substantially added to the paper work burden of investors. The SEC has been zealous in its pursuit of equal access to material information, perhaps to the exclusion of other considerations. A good example of this is In the Matter of Raymond L. Dirks[140] which involved an alleged violation of rule 10 b-5 by an investment advisor. He induced others to sell securities of a company based on information which he had imparted to them without disclosing this information publicly. This information concerned a vast insurance fraud in the company

which two former employees had uncovered and passed on to Dirks. Dirks put this information to the president of the company who categorically denied the allegations of fraud. The former employees informed various government agencies of their suspicions, but they did not take any action. The sellers sold substantial blocks of shares prior to trading being suspended and a Petition for Reorganisation being filed. The SEC asserted that Dirks and the sellers (two investment companies) were tippees who had taken advantage of inside information, and as such, were in breach of their fiduciary duties. Dirks was originally suspended from trading for sixty days but, on appeal, this was reduced to a censure. Yet it is difficult to see how Dirks acted improperly. To disclose the information publicly would have invited a defamation suit since the company president had denied the allegation of fraud. To refrain from doing anything would have enabled the company to continue its massive fraud. To inform the authorities would have accomplished little as this had already been tried by the former employees to no avail.

The Dirks case shows that it is possible for the enforcement body to get carried away with its goal of equality of access to information so as to blind itself to other considerations, particularly those of a non-legal nature.

Section 16(b) and the New York Stock Exchange listing requirements and informal control over its members, complete the comprehensive regulation of insider trading in the United States. Section 16(b) providws 'windfall' benefits to the company and takes away the profits of a narrowly defined class of insiders, even if they are not actually exploiting inside information. This is justified on the basis that insider trading is a very serious problem. It is difficult to estimate the practical effectiveness of the present regulatory set-up in the United States. However the sheer size of the markets and the distance between markets probably justify a greater degree of regulation than would be necessary in New Zealand.

VIII CANADA

The United States regulatory measures were examined at some length, partly because they constitute the most comprehensive regulatory set-up in the world, but also because they form the foundation for most other regimes' anti-insider trading provisions. Canada is one such case.

A. Initial Regulation

Insider trading regulation in Canada has, like Australia, tended to develop on a region by region basis. The leading province in terms of innovation has been Ontario, and it is that province that this paper will focus on. Insider trading first became subject to statutory regulation in Ontario in 1966 following recommendations by the Kimber Committee.[141] This reflected growing dissatisfaction with the common law control of insider trading, particularly the rule in Percival v. Wright.[142] The legislature utilised the twin techniques of an obligation to report, and liability for the misuse of information.[143] The obligation to report arose whenever the insider traded in his corporation's securities, but liability was only imposed when it could be shown that the insider had made use of specific confidential information.

The definition of 'insider' used was similar to that contained in section 16 of the Securities Exchange Act 1934 (US): directors, senior officers and shareholders who had over ten per cent of the voting shares. In addition it included inter-corporate holdings. This extended the definition of insider in three ways. First, it deemed directors and senior officers of corporations that were themselves insiders of an issuer corporation to be insiders of the issuer corporation.[144] Secondly, a corporation was deemed to own beneficially securities owned by its affiliates.[145] Thirdly, a person was deemed to own beneficially securities owned beneficially by a corporation controlled by him or by an affiliate of such corporation.[146] This definition, whilst it was wider than section 16 of the U.S. Act, was narrower than that developed by the courts with respect to rule 10 b-5. It did not include

professional advisors, junior officers or tippees. Nor did it include insiders who dealt in the securities of a corporation in which they had no interest. As such, the definition aimed to produce certainty and precision rather than comprehensiveness.

As with the U.S. Act, the insider was under an obligation to file a report when he first became an insider and thereafter whenever be traded.[147] This report was to be filed with the Securities Commission and was to be available for public inspection.[148] Monthly summaries were published by the Commission, and also by some financial newspapers. However the penalty for non-compliance of $1000 seemed insufficient and there was evidence to suggest that there was a substantial degree of non-compliance.[149] It was hoped that the wide publicity which attached to the disclosures made by the admittedly narrow class of insiders would deter them from trading in circumstances where it might seem that they were using inside information.[150]

In contrast with the much wider-reaching provisions relating to disclosure, the liability provisions only came into play when use was made of 'specific confidential information' by an insider to the detriment of the other party in a securities transaction.[151] The definition of insider was extended, based on the broad notion that those with whom the insider had close contacts in business (for example companies), or in private life (for example relatives) would be likely to be privy to the same confidential information as the insider himself.[152] Although this extended the scope of the definition of 'insider', it did not include tippees, professionals or junior officers, and there was the difficult hurdle still to be overcome of proving that the information was specific and confidential. Junior officers were excluded because it was thought that senior management itself would have an interest in ensuring that these people did not abuse their position and the possibility of dismissal would be sufficient

deterrent.[153] Similarly it was thought that professional people would be subject to the control of professional bodies.[154]

Other features of the liability provision were, first, that the information must have been such that, if generally known, 'might reasonably be expected to affect materially the value of the securities'. Secondly, the insider was liable to compensate the other party only for any 'direct loss suffered'. Thirdly, a limited defence was given where it could be shown that the party knew or ought reasonably to have known the information at the time of the transaction. Fourthly, the insider was also to be accountable to the corporation for any direct benefit or advantage that was received or receivable.[155] Any shareholder of the corporation was given the right to bring an action requiring the Ontario Securities Commission to bring the action in the name of, and on behalf of, the corporation if the corporation itself failed to do so.[156]

The provisions instituted civil liability, with the possibility of double recovery by both the other party to the transaction, and the issuer of the securities. The ambit was limited to dealings in the securities of the corporation of the insider. However, it does not appear that the insider actually had to realise the benefit in order to be liable to the issuer.[157] Corporations who received information through a 'nominee' director would be prevented from trading because they would hold more than ten per cent of the securities of the issuer. This raised problems when such a shareholder wished to trade since it could reasonably be assumed that the shareholder would always be in possession of specific, confidential price-sensitive information. Such a shareholder would seem to have had the choice of remaining 'locked in' or trading in such a way as to ensure a loss to itself, or having to defend itself in the courts if it made a profit (or caused the other party a direct loss). None of these choices appeared reasonable. Therefore, it is suggested that the information

would have had to have been very confidential, specific and price-sensitive before the courts would have allowed an action.

B. New Provisions

It was in response to some of these factors and other difficulties, particularly the difficulties of proof in showing the use of specific, confidential, price-sensitive information, and the lack of successful prosecutions,[158] that a revised Act was passed in 1978 and another in 1980.[159] Corporations that have issued securities are now required, when a material change occurs in its affairs, to issue 'forthwith' a press release disclosing the nature and substance of the change.[160] A material change is defined to mean a change which "would reasonably be expected to have a significant effect on the market price or value of any of the securities of the issuer".[161] In addition, a report of the material change must be filed with the Commission 'as soon as practicable and in any event within ten days'.[162] An exception is allowed where disclosure would be unduly detrimental, in which case a report may be filed with the Commission in confidence instead.[163] In addition, reporting issuers are required to provide the Commission with quarterly financial statements.[164] Therefore it can be seen that the legislature has made a real attempt to increase the amounts of information available to the market and thus to minimise the opportunities for insider trading whilst maximising the efficiency of the market.

The penalties for non-compliance range from $25000 in the case of a company, to $2000 or one year's imprisonment in the case of an individual, upon summary conviction.[165] The Commission also has the power, if it sees it as being in the public interest, to suspend trading in the securities of the company.[166] Although these sanctions are severe, the problem still remains of detection of breaches. There are many 'changes in the business or operations' of an issuer[167] which would not be appropriate for release -

for example, a management squabble - but which would reasonably be expected to have a significant impact on the market price. The opportunity given for a 'confidentiality' tag to be attached to the information would be unlikely to induce disclosure, especially when there is a likelihood that the tag will be taken off. It is also unclear when the obligation to disclose arises. "Reasonably be expected to have a significant effect on the market price" may be given a subjective or objective interpretation. It is certainly a stricter test than the "unreasonable and objective contemplation might affect the price of securities" test accepted in the United States.[168]

In addition to corporate disclosure of price-sensitive information, insiders[169] and their nominees[170] are required to file a report of all transfers made by them in the securities of the reporting issuer. As under the previous legislation, the reports are published monthly in summary form by the Commission.[171] Thus there has been a real effort made to prevent insider trading by promoting greater disclosure of information, and to discourage insider trading by selecting a class of insiders who are most likely to have access to inside information, by exposing them to the Commission's and the public's scrutiny.

C. Liability for Trading

The liability provisions have also been changed by the 1980 Act. The principal changes are terminological. Liability is now imposed where a "person or company in a special relationship with a reporting issuer" sells or purchases securities of the reporting issuer "with knowledge of a material fact or material change with respect to the reporting issuer that has not been generally disclosed". Furthermore liability is also imposed if the person or company communicates knowledge of that material fact or material change to another person or company who uses it to sell or purchase securities of the reporting issuer.[172] Those in a special relationship include the insiders who are under an obligation to report their trading to the

Commission,[173] the officers and employees of the reporting issuer,[176] and those who acquire the information through a business or professional relationship with the reporting issuer.[177] This substantially extends the ambit of the liability provisions. Most importantly they now include all employees, professional people and other business people who learn of information through their relationship with the reporting issuer, and tippers. Yet there is no liability for tippees.

A person who trades in a situation as outlined above is liable for damages to the other party[178] and is also liable to account to the reporting issuer for any benefit or advantage received.[179] The provisions relating to a limited defence where it can be shown that the information was not used by the insider or that the insider reasonably believed that the other party knew of the information, are retained. Also retained is the provision for the Securities Commission to bring an action on behalf of the company.

D. <u>Analysis of Provisions</u>

In summary, Canada has progressively extended its provisions relating to both disclosure and prohibition. More disclosure of price-sensitive information, and disclosure of potential insider trading transactions are the preventative measures. The curative measures are recovery of damages suffered by another party in virtually any situation where use is made of undisclosed price-sensitive information and accountability to the issuer for any profits made. The sanctions for failure to report are criminal, those for insider trading are civil. The use of civil liability perhaps reflects an awareness of the problems associated with criminal sanctions of burden of proof. The double recovery provisions reflect the difficulty, in the case of an often anonymous stock exchange transaction, of relying on the other party bringing an action as a curb to insider trading. This is particularly so when there are other forces in the market having a significant impact

on share prices. The provision allowing the Securities Commission to bring an action in the company's name recognises the difficulties that a minority shareholder may have in overcoming the 'internal management' rule and persuading the company to institute an action. In many ways the provisions could be described as 'catch-all' with the intention being to provide a remedy in all cases, even if the provisions are not able to be adequately policed. An example of this is the inclusion of tipper liability. In many cases, proof that the person passed on price-sensitive information and thereby caused loss to another party would be very difficult. In such a case it would also be difficult to show that the tipper had made a gain so as to make him liable to account to the company.

However, there are at least three restrictions on the scope of the provisions. One is that tippees who are not connected with an insider may trade without liability. Another is that the information must be shown to be expected to have a significant impact on market price. A third is that insiders will not be liable if it is shown that the other party knew the information or if they prove that they did not make use of the knowledge of the material fact. This prevents major shareholders becoming 'locked in' as they may apparently do in Australia.[180]

One question that may be posed with respect to the Canadian provisions is whether the problem presented by insider trading is so serious that it justifies imposing a vast paperwork burden on insiders every time they trade, failure to observe of which may lead them to the stigma of sanction under the criminal law. A further question which may be posed is whether the extra benefits of the extensive regulation in terms of its deterrent effect, outweigh the extra costs, so as to leave society in general, and the market in particular, in a better position than before.

IX AUSTRALIA

A. Common Law

The common law position in Australia is the same as in the United Kingdom. Up until 1961, it and self-regulation were the only means of control of insider trading. This was almost identical to the situation in New Zealand.

B. Legislative Development

The legislative developments in Australia have reflected an increasing specificity of control of insider trading. The first legislative regulation of insider trading was contained in the Uniform Companies Act 1961 which provided for the disclosure of directors' shareholdings by use of a register[181] and liability to the company for any officer who by virtue of his position gained "directly or indirectly an improper advantage".[182] 'Officer' in this context seemed to refer to persons who owed a fiduciary duty to the company. Salient points of the liability section were (1) that the company *vis a vis* the other party to the transaction was the party who benefitted and who in practice brought the action[183] (2) that there were great difficulties of proof so that it was difficult to get prosecutions and its deterrent effect was therefore negligible.

Legislation has since been passed in some States[184] extending the disclosure requirements by making access to the register easier for members of the public and by broadening the types of interests which have to be notified and registered.[185] Substantial shareholders in listed companies (those whose nominal value of voting shares exceeds ten per cent) are also required to notify the company of their interest in the company.[186] This includes nominee shareholdings.

1. Scope of provisions

In New South Wales criminal liability was introduced in 1975 for insiders in three types of

situations where they are in possession of information which if generally available, would be likely materially to affect the price of securities: (1) where the person is 'connected with a body corporate' and deals in the securities of that body corporate;[187] (2) where the person is connected with a body corporate which is at present involved in a transaction (actual or expected) with a second body corporate, and the person uses information connected with the transaction to deal in the securities of the second body corporate;[188] (3) where a tippee trades on information received from either of the two above and he knows that that person is precluded by the above from dealing in those securities and he is either associated with or had an arrangement with that person for the communication of information with a view to one or both of them dealing in securities.[189] Furthermore, these three classes of insider may not communicate that information to another person if they know that the person will make use of the information for dealing or procuring others to deal.[190] The three classes of insider themselves may not procure others to deal either.[191] A person is connected with another if he is an officer, a substantial shareholder (one who owns more than ten per cent of the shares), occupies a position that may reasonably be expected to give him access to material price-sensitive information by reason of a professional or business relationship with the body corporate or by reason of being an officer of a substantial shareholder where that shareholder is a body corporate.[192]

The effect of this seems to be that liability has been extended beyond those who owe a fiduciary duty to the body corporate.[193] However tippees are only liable if they take part in some 'arrangement';[194] so a casual tip on the golf course would not make the tippee liable. Nor would it make the tipper liable unless it could be shown that he knew or ought reasonably have known that the information would be used to deal.[195]

The provisions seem to have the unfortunate effect of precluding some insiders (particularly directors) from ever dealing in their own company's securities. This is because they will always be in possession of material price-sensitive information. No defence is provided for showing that one did not use price-sensitive information. It is an irrebuttable presumption. This may have the effect of discouraging directors from having a stake in the company, or alternatively, discouraging major shareholders from taking a greater interest in the company by taking a seat on the board.

The provisions make it clear that where a body corporate is a shareholder of another body corporate, and it uses its voting power to put one of its officers onto the board of that body corporate, then it is precluded from dealing in the securities of that body corporate unless that officer does not pass information on and that officer played no part in the decision. In view of the blanket prohibition on other insiders who deal, it seems that this is a mild provision which is inconsistent with the rest.[196]

2. Enforcement of provisions

Those who contravene the above provisions are guilty of an indictable offence and may be liable to a $10000 fine or 5 years' imprisonment.[197] In addition, if an insider within the first two categories listed above, or a company who has appointed a 'nominee' director, trades, then they will be liable to compensate any other party to the transaction for any loss sustained by that party.[198] That loss is to be measured by the difference between the price paid and the price that would have been paid had the information been generally available. In addition, an insider will be liable to account to the body corporate, in whose securities he dealt, for any profit he makes.[199] The Securities Commission may, if it considers it in the

public interest to do so, bring an action in the name of, and for the benefit of, the body corporate or other person for recovery of a loss or profit of the kind mentioned above.[200]

These provisions have been re-enacted by the Federal Parliament in almost identical form in the Securities Industry Act 1980 (Commonwealth).[201] One of the more important differences has been the inclusion of a limited defence where the insider can show that the other party knew or ought to have known of the information before entering into the transaction.[202] A general provision is also contained in the Companies Act 1980 (Commonwealth).[203] This provides that officers and employers or former officers and employees, shall not make improper use of information acquired by virtue of their position to gain, directly or indirectly, an advantage for themselves or any other persons or cause detriment to the corporation. A penalty of $20000 or imprisonment for five years, or both, is provided.[204]

3. Analysis of provisions

This legislation reflects the development of the regulatory framework from one of common law and self control and minimal interference by the legislature, to one of all-embracing legislative intervention in both the disclosure and the prohibition fields. The provisions reflect a move away from the notion that the duty is a fiduciary one that is owed to the company, to the notion that there is a duty not to use information only obtainable through one's job, which is owed to society (hence the criminal sanction), to the company, and to the individual shareholders. This reflects a move away from the sanctity of the company as a separate legal entity whose officers are responsible only to it and not to the individual shareholders.[205] It also implicitly recognises that insider trading is a serious problem which cannot be controlled by more

informal, less explicit means. By making the prohibition on trading by insiders independent of whether they actually use the information that they are in possession of,[206] and very wide in its scope, the legislature seems to have gone for a means of 'stamping out insider trading at all costs'. In doing this it does not seem to have taken full account of some of the other objectives of a securities market - for example, efficiency, provision for 'joint ventures' by equity participation, and provision for directors who are also major shareholders to enable them to change their stake in the company. By not admitting a defence based on a plea that the other party knew of the information (as is the case in Canada)[207] the legislature seems to have rejected the notion that insider trading should be prevented because of the damage it causes to the individual other party. Rather, insider trading is seen as being detrimental to the *whole market* because it gives the insider a superior bargaining position over *all* other investors, not just the particular person with whom he deals.

X UNITED KINGDOM

Up until 1980 the common law and self-regulation were the two methods of regulating insider trading used in the United Kingdom. The common law position is substantially the same as in New Zealand and has already been outlined.[207] The major limitations of the common law are first, that a confidential relationship must be shown to exist between the parties (which cuts out most stock exchange transactions), and secondly, the Foss v. Harbottle[208] rule restricts the ability of individual shareholders to bring a derivative action on behalf of the company. For these reasons, self-regulation became the most important means of controlling insider trading.

A. Self-Regulation

In response to the takeover boom of the mid-1950s, pressure from the Government and the Bank of England, and in order to pre-empt the imposition of statutory regulation and a Securities Exchange Commission, the City institutions established the City Panel on Take-overs and Mergers. The Panel consists of nine persons nominated from the various City bodies, with a small secretariat. This was expanded into a full-time Executive and an Appeals Committee was set up under a law lord chairman. The City Code on Take-overs and Mergers was formulated. The Code is expressed to apply primarily to those active in the securities industry, but also to "directors...or persons who seek to gain control of public companies, and professional advisers."[209] It is concerned with public companies only.

The Code outlines a number of General Principles and the Panel has subsequently issued Practice Notes to flesh out the detail when it is necessary. The Stock Exchange has also issued Rules for its members in line with the General Principles. One of the most important principles is contained in General Principle 5 of the Code :

> "It must be the object of all parties to a take-over or merger transaction to use every endeavour to prevent the creation of a false market in the shares of the offeror or offeree company."[210] (emphasis added)

It was thought that the problem of insider trading was mainly confined to trading by tippees and other persons who dealt on the basis of rumours, rather than trading by insiders. As such the problem to be addressed was one of security and confidentiality. The solution was seen as lying in fuller and faster disclosure of information, or temporary suspension of trading where it was evident that material undisclosed information was in the market. Emphasis was also placed on companies developing their own internal guidelines and procedures for their employees to use when handling confidential information.

The Panel issued a Statement of Policy which mentioned the sanctions that it could use. These included public and private censure,[211] reference to the Department of Trade with regard to the suitability of a person to hold a licence under the Prevention of Frauds (Investments) Act 1958,[213] reference to the relevant professional body, or suspension or delisting by the Stock Exchange of a quoted security. Many of the sanctions were of an informal nature. If the Panel discovered that an insider had improperly made a profit it would 'endorse' his gift of the profit to a charity.[213] The great advantages of this procedure were that people were willing to provide the Panel with evidence and the formal procedural difficulties of a public trial could be dispensed with. This allowed for speedy and effective action to be taken against transgressors.

One of the criticisms of this approach was that the insider got a tax advantage from the gift of the profit to charity. Another was that when the insiders decided to 'go public' themselves, particularly when their companies decided to back them up, the effect of the Panel's censure was negatived by the counter-publicity. It was also suggested

by the Press that the Panel was not persistent enough in its investigations, and perhaps not prepared to attack established 'City' people.[214]

The City Code on Take-overs and Mergers applied principally to take-overs. In the more general situation there were (and are still) other bodies which exert some form of regulatory control. The Stock Exchange, through its Quotations Department will suspend trading in the securities in consultation with the issuer where it suspects that there may be undisclosed material information about, or pending disclosure or clarification of such information. The Stock Exchange has also published a 'Model Code for Securities Transactions by Directors of Listed Companies' in October 1977. This is almost identical in its terms to the Guidelines put out by the Stock Exchange Association of New Zealand which has already been discussed.[215] The burden for enforcement of the Code is put on the board of directors as a whole. This may not be effective if the insider exerts so much control over the board that the abuse is covered up.

Other regulatory bodies include the Law Society, the Institute of Chartered Accountants, the Institute of Management Consultants, the Issuing Houses Association and the Institute of Directors. These bodies exercise differing degrees of control over their members. Some have issued guidelines specifically on the question of insider trading. For instance the Law Society's Council has stated that it would be improper conduct for a solicitor to use for his own personal advantage or for the advantage of a client or his firm or to communicate any confidential information obtained by him or his firm in the course of his professional practice.[216] The Council has also stated that although it is not improper conduct for a solicitor/ trustee to deal for his trust in the shares of a company for which he or his firm acts, or of which he is a director,

a solicitor must bear in mind that a situation of conflict could well arise where he would be precluded from using information obtained in one capacity for the protection of beneficiaries to whom he owes a fiduciary duty in another.[217] Other bodies have left this unwritten but would still consider that a 'member guilty of insider trading or of the improper disclosure of confidential information would be regarded as a suitable subject for disciplinary action'.[218]

The Institute of Directors has issued a comprehensive code of conduct which sets out the cardinal principles that a director should not trade on a short-term basis, should not use inside information to deal in securities himself or pass it on to enable another to deal in those securities.[219] This code has now been substantially revised in the light of the Companies Act 1980 (U.K.).

The strength of pressures by their peers upon persons to conform to proper ethical standards varies from one professional body to another. However it was thought by the legislature that these pressures were insufficient and that legislation was needed.

B. Legislation

Legislation was passed in 1967[220] which provided that directors and major shareholders must notify the company of their shareholdings and dealings. This was to be available to interested parties. The aim of this measure was to make insider trading more difficult to conceal. It was thought that the fact that directors could always be called upon to explain the timing of their transactions once disclosed would constitute a significant deterrent.[221]

In 1980, after prolonged discussion, criminal liability for insider trading was introduced.[222] The Act establishes three basic rules:[223]

1) an insider with inside information may not use

it to deal in the securities of the company concerned;

2) anyone who knowingly receives inside information from an insider may not use it to deal;
3) anyone with inside information may not pass it on to someone else to deal; nor, being in possession of it and without revealing that he is in possession of it, encourage someone to deal.

The concept of 'insider' in the Act is encapsulated in the phrase "an individual who is, or at any time in the preceding six months has been, knowingly connected with a company".[224] A person is connected with a company if, and only if he is a director of that company or any company in its group, an officer, employee or professional advisor who is in a position where he would be expected to have access to confidential 'unpublished price-sensitive information'.[225]

This means that tippers are caught, even if the tippee does not use the information.[226] They are also caught, even if they did not communicate the information, if they counsel or procure another person to deal in the securities.[227] Tippees are also made liable unless they did not have reasonable cause to believe that the tipper was an insider who should not disclose such information except in performance of his duties.[228]

The information must relate to specific matters relating to or of concern to the company (vis à vis general matters), and must be likely if it was generally known, to materially affect the price of the securities.[229] Therefore, a high state of knowledge must be demonstrated before an offence is proved. In addition, a complete defence is given if the insider did not 'do the particular thing with a view to making a profit or avoiding a loss (whether for himself or another person)'.[230] This recognises

that a person may have to raise money quickly to meet a pressing financial commitment although it is suggested that the person will have to demonstrate that he had no practicable alternative source of funds in order to avail himself of that defence.

The penalty for breaking the insider dealing provision is up to two years' imprisonment or an unlimited fine or both.[231] In addition the common law liability of a director being compelled to account to the company for profits made by the use of inside information is retained.

One interesting aspect of the provisions is that they apply to dealings not only on the recognised stock market within Great Britain, but also tippers when the tip is given to someone who will deal on a non-recognised stock exchange outside Great Britain.[232] This is apparently intended to stop the practice of insiders dealing anonymously, using the protection of the secrecy of Swiss Bank accounts afforded by Swiss law. This perhaps reflects the fact that the size and complexity of the United Kingdom securities market has required strict and comprehensive legislation. This perhaps distinguishes the United Kingdom securities market from the New Zealand.

The practice in the United Kingdom since criminal liability was introduced has been that prosecutions have been infrequent and successful ones even more so. This has been partly caused by the heavier burden of proof in criminal cases and the requirement to prove mens rea, but, perhaps more importantly, it has been caused by the sources of information drying up. People are willing to come forward with information if the sanction is to give the guilty party's profit to charity, and to submit him to public censure. However, people will be much more reticent if the person is liable to be labelled a criminal and sent to prison. Employers are unwilling to admit that they have a criminal in their midst. It also seems unfair that an insider who lets something slip at a party is liable

to be labelled a criminal, even if the tippees do not trade. There are some doubts as to whether the new provisions are working better than the old ones.[233] However, this does not mean that some form of legislative intervention would not be an improvement on the previous system of self-regulation. It merely means that the introduction of criminal liability may not be an improvement.

XI FUTURE REGULATION OF INSIDER TRADING IN NEW ZEALAND

Two questions may be posed concerning the need for reform of regulation of insider trading in New Zealand. First, is the present system of control through the twin techniques of court-imposed fiduciary duty, and self-regulation, adequate? Secondly, if not, would legislation of any of the types implemented in other countries be applicable to New Zealand so as to leave the securities market in a better state than it is in under the present regulatory set-up?

A. The Present System

It is extremely difficult to say with any degree of certainty how much insider trading actually goes on in New Zealand. However, in attempting to discuss how much does go on, it is useful to bear in mind the various types of insider trading that can go on. Reference was made earlier to the concept of a set of concentric circles of insiders centring on the corporation.[234] As the circle of insiders widens, the strength of the relationship between the insider and the corporation diminishes. Directors would probably be within the narrowest circle. Tippees within the widest.

Taking the narrowest circle of insiders first, it would appear that the amount of insider trading by directors of public companies is probably negligible and almost certainly tolerable. Most of those interviewed were unaware of more than a couple of cases having occurred. In this area it seems that the informal sanctions of peer pressure and fear of loss of reputation work reasonably well. The lack of insider trading may also be a consequence of the large number of interlocking directorships in New Zealand. For a market containing such a large number of interlocking directorships to work smoothly, a high degree of mutual trust is required. This in turn demands high ethical standards. The smallness of the pool of managerial expertise resources in New Zealand means that everyone is 'close' to one another. This makes it very difficult

to act unethically and not be detected. There do, however, appear to be cases of people trading in relations' names or through nominees which are not easily detectable under the present set-up.

Secondly, examining the situation of major shareholders, similar comments apply. The real distinguishing feature from the ordinary director case is when the shareholder receives information through a 'nominee' director. It was suggested earlier that, in principle, such a shareholder should be treated in the same way as if it (or he) sat on the board itself (or himself). However, there seems to be some ambiguity as to when that shareholder is free to deal, or even, when the 'nominee' director is free to pass information on to that shareholder. It is clear what constitutes 'good' practice but it is unclear what constitutes 'adequate' practice. A good example of what constitutes good practice was when the BNZ increased its shareholding in BNZ Finance in 1981.[235] In that case the BNZ Finance board comprised both BNZ 'nominees' and independent outsider directors. After BNZ announced that it wanted to increase its shareholding, the nominee directors left the meeting and the remaining directors decided whether to recommend acceptance and sought an independent valuation of the shares. This was to ensure that the transaction could take place at 'arm's length'.

Just what exactly constitutes the minimum standard of conduct in the case when the shareholder wants to change its holdings is unclear. What is clear is that shareholders who receive information through a 'nominee' director should not expect to change their shareholding, at least in the immediately foreseeable future. One managing director of an insurance company told the writer that if his company held a substantial shareholding in another company he would not seek to appoint a nominee to the board of that company if there was a prospect that his company might want to change its holding. If his company did appoint a director he would regard it, except in exceptional circumstances, as

being 'locked in'. Indeed there was a recent example where a board of a public company refused to permit two major shareholders to appoint 'nominees' onto the board without shareholders' approval because it feared that the shareholders were likely to change their shareholding. The inference was that the shareholders would want to change their shareholding based on what they had learned through their 'nominees'.[236] Some further controls may be required in this area.

Thirdly, widening the circle of insiders a little to include employees, it is at once apparent that some employees are more likely to have access to price-sensitive information than others. First, junior employees are not as likely to have access to price-sensitive information. Secondly they are unlikely to have a sufficient overall picture of the corporation to be able to recognise the true significance of any particular piece of inside information they do come across. Finally, they are more likely to be subject to supervision from management above, and the sanction of instant dismissal if they are caught insider trading.

Senior employees on the other hand (the distinction between senior and junior is arbitrary and a matter of degree), are more likely to have access to inside information and less likely to be subject to control. Some firms rely on 'secrecy' contracts to control these employees (especially accountancy firms) but the majority rely on ethical standards, as manifested in the internal rules of the corporation. Another means of control is through the board's supervision of sharedealings. Unless the employee trades through a third party (a relation, friend or nominee) the particulars of the share transfers will turn up on the share register. The board would then be able to inquire into the reasons behind the transaction if it appeared that price-sensitive information might have been used. Although it must be conceded that it is almost impossible to find out exactly how much insider trading of this type does go on,

it is suggested that in fact there are very few employees within any corporation who will have access to truly price-sensitive information. Others may hazard guesses but are as apt to get it wrong as they are to get it right. Therefore, given the lack of reported cases, it is suggested that insider trading by employees is not a serious problem.

Fourthly, examining the position of lawyers, accountants, stock-brokers and other professional advisers, it is clear that although they will be likely to have access to inside information, they are very much bound by the ethical standards of their professions, much in the same way as directors. If professionals do trade on inside information and they are found out they can be disciplined by their professional body, and may even lose their right to practice. Therefore, it is suggested that such people are adequately controlled.

It is sometimes suggested that stockbrokers may not be adequately controlled. After interviewing several brokers, it is the opinion of the writer that the strict disciplinary measures that attach if a member of a stockbroking firm is caught insider trading are sufficient deterrent. Where the argument may have a little more validity is in the area of tippees. Some of the brokers spoken to did not seem to have any compunction about passing information concerning non-clients to their clients. This was seen as being within the general scope of their function as information gatherers, collators and disseminators. The problem of tippees has already been discussed in some detail.[237] Applying some of the considerations discussed above to stockbrokers, it would be unreasonable every time a stockbroker came into possession of what appeared to be price-sensitive information, to expect him to desist from using that information until the source of it had been checked. Therefore unless the broker actually knows that the insider was breaking a confidence in disclosing the information there seems to be

nothing wrong with him advising his clients of the information or the implications of the information. It is the writer's view that unless the insider gives the information to the broker in confidence, the broker should be allowed to use the information for the benefit of his clients. The insider's impropriety in divulging the information to the broker should not affect the broker's propriety in using it unless there is a 'scheme' between the two.

Brokers who break confidences, such as by passing on information learnt from one client to another, are subject to the same sanctions as any other profession. The individual concerned is liable to be disciplined by the firm. He is likely to be 'blackballed' by his peers. His firm is likely to lose accounts to those with better reputations. He may even be summoned to appear before the disciplinary committee of his professional body, in which case he may lose his right to practice. Brokers then, for the most part, appear to be adequately controlled.

Fifthly, an insider may deal in securities of a corporation other than his own. This may come about where the insider's corporation is taking part in negotiations with another corporation, and the outcome of the negotiations may have an effect on the securities prices of both corporations. There seems to be very little check on this type of trading. If the insider does not feel that his conduct is likely to be revealed, he may be more willing to risk his reputation in search of profits. Insider trading in the securities of other corporations may be insufficiently controlled in terms of supervision, but it is suggested that if ethical standards are an adequate means of control in other areas, it is unlikely that insiders will drop their standards in this area just because the supervision is not so great.

B. The Alternatives

There appear to be six principal modes for regulation:

1) more disclosure required by the legislature and the stock exchange
2) a change in the standard of conduct required by the stock exchange and other professional bodies
3) a development by the courts of the concept of a fiduciary duty
4) a statutory reversal of Percival v. Wright[238] to allow all minority shareholders to bring an action in the courts, either in their own right or on behalf of the company
5) the establishment of a statutory regulatory body, such as a Securities Commission with powers of enforcement
6) the introduction of criminal liability for insider trading.

These modes will be discussed with reference to the principles of the regulation of insider trading established in the first part of this paper and to the regulatory examples of the United States, Canada, Australia and the United Kingdom, and to the views of those who were interviewed by the writer.

1. Disclosure

There are two ways in which more disclosure can be used to discourage insider trading. The first is where corporations are required to disclose more information to the market. The second is where insiders are required to disclose their securities dealings.

First, there are several ways of promoting disclosure of information. The stock exchange can increase the detail required to be contained in corporations' annual reports by changing its listing

requirements. It can also increase the frequency of reports, for instance by requiring them to be filed quarterly. This will reduce the opportunities for trading on regularly occurring price-sensitive information. This will also promote efficiency in the market by ensuring that information concerning the corporation's present level of performance is speedily and accurately reflected in the security price.

Price-sensitive inside information of an exceptional nature poses greater problems to a regulator seeking to ensure full disclosure. Information of an exceptional nature can occur in two ways: instantaneously or slowly building up over time. In the case of 'instantaneous' information, the corporation should be required to disclose it as soon as feasibly possible. If it would be unfair to require the corporation to publicly disclose the information, the corporation should at least be required to notify the stock exchange. The stock exchange could then suspend trading, if necessary, pending a full announcement.

Information which is uncertain and unspecific at first and which becomes more price-sensitive over time (as the project 'firms' up and the detail is worked out), is much more difficult to deal with. It may not be in the corporation's interest to disclose: for example, where sensitive negotiations are in progress. It may also be very difficult to pinpoint exactly when the obligation to disclose would arise. Suspension of trading would not work so well in this case because the corporation is likely to want to keep the information confidential for quite long periods of time. If information of this kind was to arise very often, the shares would never be traded. Therefore, there will inevitably be gaps in any information disclosure provisions.

Secondly, dealing with disclosure of insiders'

security transactions, there is already provision for directors' and shareholders' (owning five per cent of the shares or more) beneficial and non-beneficial shareholdings and share transactions to be kept in a register on the corporation's premises.[239] The stock exchange also requires directors' shareholdings to be published in the Annual Report, and to be available at the General Meeting. It may be a useful addition to require relations' shareholdings and transactions to be filed on a register also.

A problem may occur if the directors or relations trade using nominees to hide their identities. The listing requirements require the disclosure of nominees and those who are beneficially entitled to the shares. This does not catch those non-directors who hold less than five per cent of the shares who trade using nominees. There has also been a good deal of non-compliance with this requirement.

The Securities Commission has recently been looking at the use of nominees.[240] It currently has a proposal before the government which would make it compulsory for any shareholder who owns over five percent of the shares of a company to declare his interest.[241] Penalties for non-compliance would include civil remedies such as cancellation or recovery of damages, disqualification from voting, restrictions on payment of dividends or other benefits such as bonus shares, orders for forfeiture of the securities to the company, and orders for disposal of the securities.[242] These would be useful measures. However they are directed more at the surreptitious take-over than at the small-time insider trader.

One alternative that has been used elsewhere is to require all those who are likely to have access to inside information to register their shareholdings and their transactions. As one would not expect these people to

be dealing in the shares of the company on a short-term basis, this would not impose too much of a burden on them. Therefore, the disincentive to trade (and consequent detrimental effect on market efficiency) would be minimal, providing they were trading for bona fide reasons. A practical problem might occur if the circle of insiders required to report was defined widely. For instance, if directors, major shareholders and senior employees of the company, its subsidiaries and associates were included, the number of reporters for a single company might run into several thousand. In such a situation it is unlikely that any meaningful check could be maintained by directors on insider transactions. Therefore, it is suggested that the definition of insider for reporting purposes must be a relatively narrow one. This would also be in line with the view expressed earlier that there are few people in a company who are going to be in a position, both to have access to inside information and to take advantage of it.

Increased disclosure has the advantage of promoting efficiency and equity in the market at the same time. It brings insider trading out into the open. The possibility of public scrutiny has a prophylactic effect of discouraging insider trading. It is also relatively easy to implement, to enforce, and to supplement if necessary. For these reasons, increased disclosure must be the primary focus for regulators of insider trading.

One possible disadvantage of increased disclosure of information is that there will be so much released, in such a disordered way, that it will be unintelligible, or worst still, misleading, to the ordinary investor. There are at least two solutions to this: first, ensure that disclosure conforms to a standard, understandable format. Secondly, promote public education concerning the securities market, and encourage the use of financial intermediaries.

There are limits to the impact of more disclosure. Some information is not of a form suitable for release, though it is still price-sensitive. Some insiders will find a means of evading the disclosure provisions, by trading through nominees (such as friends) and hence will remain undetected. Therefore, some methods of control are needed.

2. Stock exchange rules and guidelines

One method of control is the development of something akin to the City Code on Take-overs and Mergers in London. A regulatory body would be set up with representatives from the Stock Exchange Association, the Institute of Directors, the Listed Companies Association and any other interest groups such as lawyers and accountants which are deemed appropriate. This body would have a power of investigation similar to that of the stock exchange: although it has no legal power, it has an informal power which is recognised by listed companies. If a company refused to permit an investigation, its shares could always be de-listed. The body could act on complaints by shareholders and publish its findings. It could, if necessary, refer the case to the appropriate corporation or professional body. Where it found that a profit had been made it could 'require' the offender to make a donation to a nominated charity.

This procedure has the advantages of providing a relatively informal means of dealing with insider traders, providing a detection mechanism and remedies with sufficient teeth to deter most insiders, whilst not imposing a burden on the remaining bona fide traders. It has the disadvantage that it will not stop the determined insider trader. It is unlikely to prevent the 'big boys', who receive information through 'nominee' directors from trading, because they are capable of withstanding the sanctions. However, it is suggested that even the 'big boys' are jealous of their reputations and are unlikely

to fly in the face of an informal body consisting of their peers.

Before the implementation of this proposal is considered, it is necessary to show that the existing procedures have not dealt with the problem of insider trading adequately. Assuming that they have not, then a tightening of some of the stock exchange rules may be appropriate. The position of shareholders who receive information through 'nominee' directors could be explicitly stated in a similar manner to the position of offerors and offerees in the Take-over Code.[243] If this was still insufficient, only then would the establishment of such a body as the Panel on Take-overs and Mergers be necessary.

3. Increased scope of fiduciary duty

At present, the courts are willing to recognise a fiduciary duty owed by directors to their corporations, but not to individual shareholders. The courts, in the absence of some special relationship, seem unwilling to recognise a fiduciary duty on the part of employees or professional advisors. They also seem to be unwilling to recognise derivative actions by individual shareholders.

It is suggested that the courts, with respect to insider trading, should seriously consider implementing the following: (a) recognise that a wider group of people than merely directors are responsible for the management of a modern company, who should thus be subject to fiduciary duties; (b) allow individual shareholders to bring an action on behalf of the company when an insider trades on inside information; (c) allow individual shareholders to bring an action in their own right.

The cause of the courts' reluctance to pursue these suggestions has been the predominance of the notion

of the company as a separate legal entity, whose directors are responsible to it for its management, and to it alone. As has been noted elsewhere:[244]

> "the increasingly complex transactions of the business and financial communities demonstrate the inadequacy of the traditional theories of fiduciary obligation as tests of majority shareholder responsibility. These theories have failed to afford adequate protection to minority shareholders and particularly to those in closely-held corporations whose disadvantageous and often precarious position renders them particularly vulnerable to the vagaries of the majority."

There seems to be:[245]

> "a growing realisation that there is an inherent contradiction in a set of rules which require corporate directors to manage the corporation in good faith for the interest, welfare and advantage of the corporation, the ultimate test of which is the interest of the shareholders as a whole, and yet at the same time allows the directors to antagonise the shareholders individually. The fetish of a separate corporate entity must be removed in order to deal with the merits of the situation."

These are comments with which the present writer respectfully agrees, but they must be applied to insider trading with caution. As Mahon J. said, "the concept of corporate management would collapse if there was any general rule that the directors were also the fiduciary agents of the shareholders."[246] It is suggested that when a director indulges in insider trading, he is not acting in pursuance of any corporate function. He is acting for his own benefit, possibly to the detriment of the shareholders. Therefore, in principle, he should on occasions be liable to individual

shareholders. Some judicial willingness to look beyond the company as a separate legal entity was shown by Lord Wilberforce:[247]

> "The words [just and equitable] are a recognition of the fact that a limited company is more than a mere legal entity with a personality in law of its own: that there is room in company law for recognition of the fact that behind it, or amongst it, there are individuals, with rights, expectations, and obligations inter se which are not necessarily submerged in the company structure."

Whilst extension of the fiduciary duty of directors to include individual shareholders provides considerable scope for future regulation of insider trading, particularly in smaller private companies, the apparent reluctance of the courts to go behind the corporate veil means that extensive development in this area is unlikely.[248]

An alternative to imposing a fiduciary obligation on directors to individual shareholders is to allow minority shareholders to bring a derivative action on behalf of the company. The major disadvantage of allowing individual shareholders to bring derivative actions is that the board of the company may decide, in a quite bona fide fashion, that it would not be in the company's best interests to bring an action. This may be because of the resultant adverse publicity that such an action would attract, or the large cost involved in bringing such an action. If the minority shareholder were to be permitted to bring an action on the company's behalf it would have the effect of substituting his judgment for the board's judgment. In the absence of mala fide on the part of the board, this seems difficult to justify, particularly if the writer's previously stated opinion is accepted that insider trading is not a very serious problem in New Zealand. One less

severe alternative would be for the courts to relax the exceptions to the Foss v. Harbottle[249] rule. At present, before a minority shareholder can bring a derivative action, he must show fraud on the part of those in control of the company. "Control' in this sense has been defined narrowly to mean voting control.[250] It is suggested that this should be extended to include 'de facto' control where it can be shown that the control by the insider of the affairs of the company was such that the company was prevented from properly deciding whether or not to bring an action.[251]

Furthermore, it is suggested that a wider body of insiders should be subject to a fiduciary duty. Companies have, in many cases, increased in size and complexity to the extent that they are no longer managed solely by the directors. Executives play very important parts in the strategic management of companies. So too do professional advisors. Therefore, it is suggested that some recognition should be given of the fact that these people are performing functions akin to those of directors.

Moreover, companies are more than mere legal entities. They have expanded in size and power immeasurably since they were first recognised as separate legal entities last century. They are now more responsible to society as a whole. Therefore, insider trading, which is potentially damaging to society because it undermines the confidence of those who invest their capital in the securities market, should be controlled. The traditional theory that directors are controlled through being accountable at the Annual General Meeting is not the reality. In practice, they are subject to little ongoing accountability. Therefore, the courts have an important role to play on behalf of society in preventing directors from abusing their positions.[252]

However, given the courts' conservative view of the

scope of fiduciary duties owed to individual shareholders (as shown by the New Zealand Court of Appeal in Coleman v. Myers[253]), and their conservative view of when individual shareholders may bring derivative actions (as shown by the English Court of Appeal in Prudential Assurance v. Newman [254]), there does not seem much cause for hope that the courts will see fit to extend the scope of fiduciary duties in the ways suggested. New Zealand courts are much more reluctant to adopt a law-making role than their American counterparts. They are very unlikely to develop the comprehensive civil liability rules as the American courts have done. Therefore, whilst some broadening of the concept of the fiduciary duty in terms of who it is owed by, and who it is owed to, would be welcome, any significant expansion in its scope by the courts would seem to be unlikely.

4. Statutory introduction of civil liability

The legislature could introduce civil liability along similar lines to that already introduced overseas: liability for damages to the other party to the transaction, and liability to account to the company for any profit gained. This legislative intervention could be justifiable on the ground that, since a company is a legal fiction which is a creature of statute, it should also be regulated by statute. The legislature could also legitimately claim to be acting on behalf of society because insider trading can be seen as a societal problem.

There are a number of problems (apart from those already referred to in relation to fiduciary duties) which would have to be overcome before general liability to individual shareholders could be implemented. First, there is the very real practical problem of designing provisions, which are not easily avoided and thus act as a deterrent, yet do not place an undue burden on bona fide traders and thus are conducive to market efficiency. How wide the definition of insider should be is a problem that has not been satisfactorily resolved

by other regimes. Should it include relatives, flat-mates, professional people, tippers and tippees as well as directors, senior employees and major share-holders?[255] Should it extend to subsidiary companies and their officers, and other companies over which an insider exerts a considerable influence? The elements of the offence must then be defined: how specific must the information be? How price-sensitive? From whose viewpoint is this to be judged? There is little unanimity of thought as to what constitute the proper answers to these questions.

Secondly, there is the problem of detection. If the other party to the transaction is to be relied on to enforce liability there must be some way he can detect when the insider is trading on inside information. This may be possible in the more blatant cases where the parties are dealing face-to-face,[256] but it is most unlikely in the case of stock exchange transactions. In most stock exchange transactions the outsider is unlikely to even know who the other party is. Assuming he does, then the problem still remains of discovering that the other party was dealing on inside information and proving this in a court. It is suggested that the problems of detection, particularly when the insider hides behind a nominee, make recovery by individual shareholders ineffective as a regulatory tool.

Thirdly, before the outsider could recover he must have shown that the insider owed a fiduciary duty to him. This would seem to imply that he would have to be a shareholder. He would then have to show that he had suffered loss, and that this was caused by the insider. This would involve some consideration of what the position would have been had the insider disclosed the information. It would be very difficult, where a number of different factors are influencing the share price at any one time, to show how much of the change in price was due to the

insider's information. It is suggested that all these factors could be proved only in exceptional circumstances. Therefore, civil liability per se is not feasible as the primary tool for the regulation of insider trading.

5. Self-regulation v legislation - which for New Zealand?

None of the overseas regimes considered have relied solely on civil liability to regulate insider trading. Self-regulation has been superceded in each regime by criminal liability and (except in the United Kingdom) by civil liability and the establishment of a Securities Commission. Civil liability provides the company and the other party with a remedy (in case damage can be shown). Civil actions have lower burdens of proof than criminal actions. By providing a remedy of damages, civil liability also provides an inducement for detecting insider trading.

Criminal liability is necessary because civil liability, as has been shown, is inadequate as the sole source of control of insider trading.[257] Criminal liability increases the stigma attached to the insider trader. An insider, who might possibly be prepared to do something immoral, and pay the consequences if caught, might be deterred by the prospect of being labelled a criminal. In practice, criminal liability has been used sparingly,[258] and is reserved for use in the particularly serious cases.

The Securities Commission is necessary as an overseer of the securities market. It in many cases replaces criminal prosecutions by bringing an action itself, or on behalf of the issuer company, or by compelling the issuer company to bring an action (upon application by a minority shareholder). The Commission can police the market, and inquire into any sharp, unexplained price changes.

Given that the disclosure provisions cannot eliminate all opportunities for insider trading, the choice becomes one of self-regulation or comprehensive statutory intervention consisting of the three elements just outlined. It is the writer's view that comprehensive legislative intervention is inappropriate for New Zealand at present.

First, it is suggested that no amount of legislation is going to completely eliminate insider trading. By formulating comprehensive provisions, one is only inviting the unscrupulous insider to devise means of defeating them - either by legal or illegal means. If the former, he will feel he is acting legitimately by observing the letter of the law. The spirit of the law may be lost. One of the great advantages of the present set-up is that the concept is clear but it has not been spelt out in a too comprehensive manner. Therefore one is invited to adhere to the spirit rather than the letter.

The enforcement of the legislative provisions will, of necessity, be discretionary and discriminatory.[259] The provisions will be incapable of precise definition because there are so many types of corporate insiders and inside information. If the definition is narrower, the provisions will be easy to avoid. If the definition is wide, the provisions will only be capable of being partly enforced. The Commission and other enforcement bodies will be constrained by limited resources. With the threat of a criminal sanction hanging over an insider, evidence will be difficult to procure. With the heavy burden of proof, successful criminal prosecutions will be difficult to obtain.[260] Furthermore, the cost of policing the provisions will be vast. Even taking a case to court will mean incurring expenses out of all proportion to the harm done to other investors, or the market. If a cost/benefit analysis were done, it is unlikely that the legislative provisions would be justified.

There is a cost to all the 'innocent' traders also. Directors and other insiders may feel that they are safer not to have shares in their companies. This would be contrary to the present predominant belief that it is beneficial for directors to have an interest in the companies they control. In many cases it would be very difficult for insiders to ever trade, because they would always be in possession of price-sensitive information. The 'innocent' traders would also have to carry a 'red tape' burden: for instance, having to file details of all their transactions with the Securities Commission. This would not seem to be justifiable if the enterprising scoundrels were still able to avoid detection. It would be imposing a burden for nothing. It would also be detrimental to market efficiency by putting an impediment in the way of trading.

Secondly, an abstain or disclose duty would lead to inefficiency. There will always be some information which, because of its nature, can not or will not be released. Trading on this information may be the only way of bringing it into the market: for instance by allowing tippees to trade. The price to be paid for this increased efficiency may well be the insider's profit. This recognises that ethical conduct is not the sole objective of the regulator. As unpalatable to the legal theorist as it may be, society may well be better off overall with the information 'in the market' through insider trading than it would be with the information out of the market.

Thirdly, the introduction of civil and criminal liability would run contrary to the present legal theory regarding corporations, that a director owes a duty to the corporation, (and in some cases to the shareholders as well) and other insiders only owe a duty to the corporation. Most of those interviewed thought that, at the most, a director owes a duty to the shareholders.

Imposition of criminal liability would mean that the insider would owe a duty to society, and civil liability would introduce a duty to the market. Whilst this is in line with the damage caused by insider trading identified earlier, it is suggested that the damage would have to be great to justify intervention on this scale.

Fourthly, civil and criminal liability, whilst it has some deterrent effect, does not address the major problem of the regulator dealing with insider trading - namely, detection. It is suggested that in most cases the sanctions, such as loss of reputation and job, are sufficient, once the insider trading has been detected. Therefore it is difficult to see how the introduction of civil and criminal liability will add anything. A more positive approach would be to set up an informal self-regulatory body such as the City Panel.

Finally, one is never going to eliminate completely inequalities of bargaining power. Therefore it is a matter of regulating in such a manner as to strike a balance between reasonable protection of the investing public and the imposition of a scheme that would be unduly restrictive, and indeed, have a detrimental effect.

XII CONCLUSION

If the legislative reform of insider trading is to take place, the onus is on the legislators to show that legislation is going to make the securities market in particular, and society in general, better off. The case for more disclosure of corporate information and shareholdings is compelling. Whether this is best achieved by the pre-existing bodies within the market by themselves, or whether legislative intervention is required, is unclear.

It is suggested that control of insider trading should remain with the courts and the self-regulatory bodies within the market. Legislative intervention does not seem to be justified. The smallness and closeness of the New Zealand securities market make the legislative schemes devised in other countries, inappropriate to New Zealand. The view of most of those interviewed was that insider trading is not a serious problem in New Zealand. Where some ambiguity arises, such as the position of major shareholders who receive price-sensitive information through 'nominee' directors, the bodies within the market (such as the Stock Exchange Association) can devise model rules of practice, which will be followed by the majority. The small number of scoundrels who will evade or ignore these ethical rules are not going to be satisfactorily dealt with by any regime. Therefore, the introduction of a comprehensive legislative regime does not seem to be justified.

FOOTNOTES

1. Securities Act 1978.

2. See The Bing Harris Report, The Dominion, Monday 5 April 1982, pp 9-10 or 'the Bing Harris Report' which was published by the Securities Commission. In the Commission's Report to Parliament for March 1982 year, it included in its future programme :

   "Review of the law and practice relating to the duties, responsibilities and liabilities of officers of entities that have issued securities to the public, with particular reference to the use of information relevant to the value of the securities and insider trading". (emphasis added)

3. [1977] 2 N.Z.L.R. 225, [1977] 2 N.Z.L.R.298 (C.A.).

4. E.g. Bing Harris Co Ltd., Canterbury Frozen Meat, BNZ Finance, Neil Holdings.

5. Loc. cit. n.2 at p.10 of the Dominion or p.31 of the Bing Harris Report.

6. The businessmen interviewed included inter alia: (see separate sheet).

7. B.A.K. Rider and H.L.Ffrench The Regulation of Insider Trading, 1979 MacMillan Press Ltd., London, pxiii.

8. The director is "appointed" in the sense that the major shareholder uses its superior numerical voting strength to vote him on to the board.

9. See 'The Bing Harris Report', loc. cit. n.2.

9A. A good example is the evolution of a possible takeover bid from a statement of general aims and intentions on the part of the offeror to a precisely articulated scheme of acquis- ition involving a definite price per share: Green v. Charterhouse Group Canada Ltd (1976) 12 OR (2d) 280 (C.A.), affirming [1973] 35 DLR (3d) 161 (H.C.).

10. See for example Coleman v. Myers, supra n.3.

11. See Comment "Section 16(b) Blau v. Lamb - Purchase and Sale as an Indicator of Judicial Trends"1 Georgia LR 108 as quoted in B.A.K. Rider and H.L. Ffrench" Should Insider Trading be Regulated?" (1978) 95 SALJ 79, 100.

12. H.G. Manné Insider Trading and the Stock Market (1966) The Free Press, New York at p.47.

13. H.G. Manne "Insider Trading and the Law Professors" (1969/70) 23 Vanderbilt LR 547 at 552.

14. Op. cit., n.12.

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15. Extract from an Address to the Auckland District Law Society printed in its monthly professional bulletin Northern News Review (1982) volume 7, number 2, page 1. The Address was given by an Auckland barrister and Securities Commission member, Mr J. Fernyhough. See also Manne, loc. cit. n.13 at 566.

16. L. Loss "The Fiduciary Concept as Applied to Trading by Corporate 'Insiders' in the United States" (1970) 33 Mod. L.R. 34, at 36. See also Comment "Insider Trading on the Open Market: Non-disclosure and Texas Gulf Sulphur" (1969) 42 So. Cal. L.Rev 309, at 313-314.

17. Trevor v. Whitworth [1887] 12 App Cas 409, (H.L.). Although in the United Kingdom this has been reversed by statute - Companies Act 1981 (U.K.). This follows several other countries (including the United States) in allowing companies to purchase their own securities. In view of this, the position must be regarded as 'in limbo' in New Zealand.

18. See the comments of Fuld C.J. in Diamond v. Oreamuno (1969) 24 N.Y. 2d 494 at 499. These were adopted in Schein v. Chasen (1973) 478 F.2d 817 (2nd Cir.) at 822 by the Court of Appeals.

19. See Rider and Ffrench, op.cit. n.7 at p.2.

20. A company may be wound up if a director acts in their own vis à vis the company's interests: Companies Act S.217(da).

21. Manne, "In Defence of Insider Trading" (1966) 44 Harv.Bus. Rev. 113.

22. Idem.

23. Idem.

See also Insider Trading and the Stock Market op.cit. n.12 This book was the subject of controversy and often heated discussion: R.A. Schotland "Unsafe at any Price: A Reply to Manne, Insider Trading and the Stock Market" (1967) 53 Virginia LR 1425; W. Painter "Manne, Insider Trading and the Stock Market" (1967) 35 George Washington LR 720; J.A.C. Hetherington (1967) Wisconsin LR 720. See also D. Ferber "The Case against Insider Trading: A Response to Professor Manne" (1970) 23 Vanderbilt LR 621, and H.G. Manne "A Rejoinder to Mr Ferber" (1970) 23 Vand. LR 627. Professor Manne replied to his critics in "Insider Trading and the Law Professors" (1970) 23 Vand. LR 547.

24. (1966) 255 F. Supp. 262; rev'd (1968) 401 F.2d. 833.

25. Manne "Insider Trading and the Law Professors", loc.cit.n. 13 at 550-551.

26. Phipps v. Boardman [1967] 2AC 46 (H.L.) per Viscount Dilhorne at 89-90, Lord Hodson at 107, cf Lord Upjohn at 127; Regal (Hastings) v. Gulliver [1942] 1 All ER 378 [1967] 2 AC 134n; Selangor United Rubber Estate Ltd v. Cradock (No.3) [1968] 2 All ER 1073, 1104.

27. Rider and Ffrench op.cit. n.7 at p.88. The authors express the view that "informational inequalities will always exist; they are creatures of time, distance and inequalities of wealth. Informational parity would be largely meaningless without equalities in other areas, such as comprehension, evaluation and ability to execute".

28. Manne, Insider Trading and the Stock Market op.cit. n.12, at p.47 et seq.

29. Manne, "Insider Trading and the Law Professors" loc.cit. n. 13 at 575.

30. See earlier discussion under "Definition".

31. Manne Insider Trading and the Stock Market op.cit. n.12 at 96. On the New York Stock Exchange, on average, only about 0.27 percent of total shares are traded in a week.

32. Ibid, at p.110.

33. Ibid, at pp.100-101.

34. See H. Heller "Chiarella, SEC Rule 14e-3 and Dirks: Fairness versus Economic Theory" (1982) 37 Bus.Law. 517 at p.521.

35. In the Matter of Raymond L. Dirks, Fed Sec L.Rep (CCH) no.82, 812 (1981).

36. See Heller loc. cit. n.34 at p.533.

37. L. Loss (1970) 33 Mod. LR 34, at 36.

38. See discussion under "Possible Areas of Impact of Insider Trading".

39. P.J. Carroll "Insider Trading in New Zealand" Unpublished LL.M. Research Paper, V.U.W. 1979 at p.33.

40. See discussion under "Present Regulation in New Zealand" infra.

41. Manne Insider Trading and the Stock Market, at p.111 et seq.

42. Ibid, at p.123.

43. Manne, "In Defence of Insider Trading" loc.cit. n.21, at p.117.

44. Ibid, at p.118.

45. Supra n.23.

46. This raises the question whether the user of material, non-public information should be given an opportunity to show that the exploitation of that information represents a legitimate reward for the economic effort by him or by the person who provided him with the information. See Fleischer, Mundheim and Murphy, "An Initial Enquiry into the Responsibility to Disclose Market Information" (1972/73) 121 U. Pennsylvania L.Rev 798, 816.

47. This suggestion was made to the writer by one of the interviewees.

48. See L.S. Sealy "Fiduciary Relationships" [1962] CLJ 69 and [1963] CLJ 119, and "The Director as Trustee" [1967] CLJ 83.

49. In law, directors must act "bona fide in what they consider - not what a court may consider is in the interests of the company" - per Lord Green MR in Re Smith & Fawcett Ltd [1942] Ch. 304, at 30b (C.A.).

50. See the three general propositions put forward by Romer J. in Re City Equitable Fire Insurance Co Ltd [1925] Ch.407, at 427-30.

51. For example Re W & M Roith Ltd [1967] 1 WLR 432 where the controlling shareholder and director of two companies wished to make provision for his widow without leaving her his shares. He entered into a service contract with one of his companies whereby on his death she was to be entitled to be paid a pension for her life. The court held that the company was not bound by the contract because no thought had been given to whether the transaction was for the benefit of the company, and that it seemed that the sole object was to benefit the widow.

See also Millers (Invercargill) Ltd v. Maddams [1938] NZLR 490 (C.A.).

52. See Bell v. Lever Bros Ltd [1932] AC 161, which supports the proposition that a director may become a director of a .ral company. But in Scottish Co-operative Wholesale Society v Meyer [1959] AC 324, Lord Denning held that in a case of conflict of interest, the 'nominee' directors were not allowed to subordinate their duty to the'subsidiary' in favour of their duty to the 'parent'. If they did so they acted in a 'manner oppressive to the other shareholders".

53. See discussion of whether such a shareholder should be regarded as a tippee under "Tippees", infra.

54. When one is examining at law, whether a profit has been made, it is suggested that traditional accounting principles of what constitutes a 'realised' profit are not useful.

55. New Zealand Society of Accountants, S.S.A.P.2.

56. Salomon v. Salomon & Co.Ltd [1897] AC 22; Gramophone and Typewriter Ltd v. Stanley [1908] 2 KB 89.

57. See Scottish Co-operative Wholesale Society v. Meyer, supra n.49; Re Five Minute Car Wash Service Ltd [1966] 1 All ER 242 at 247; Re Tivoli Freeholds Ltd (1972) V.R. 445 at 456.

Contrast Re Tivoli where the major shareholder, Industrial Equity, held fifty-five percent of the shares, with Prudential Assurance Co Ltd v. Newman Industries Ltd (No.2) [1980] 2 All ER 841, [1982] 1 All ER 354 (C.A.); where the major shareholder held only 25.6 percent.

58. See discussion opposite n.89 infra.

59. See Regal (Hastings) v. Gulliver n.70 infra where a tippee was a solicitor but was not held to account for profits he made. Similarly, the companies who bought shares on the basis of information received through one of the directors were not held liable to account on the basis that they owed no fiduciary duty.

60. In the Texas Gulf Sulphur case which will be discussed in greater detail later, infra n.126, the concept of a duty to the investing public was discussed, obiter at 848-849.

61. Schein v. Chasen (1973) 478 F.2d 817 (2nd Cir.), at 822.

62. Loss (1970) 33 Mod LR 34, at 37. The reference was obtained from Manne, Insider Trading and the Stock Market, op.cit. n.12 as a footnote n.42 to p.15 of the text.

63. Report of the Attorney-General's Committee on Securities Legislation in Ontario (The Kimber Report) 1965 at para. 2.02.

64. Companies Act 1980 (U.K.) S.68; Securities Act 1934 (U.S.) §10, 14, 16 and the various rules promulgated under the Act by the SEC, especially rules 10 b-5, 14 e-3; Securities Industry Act 1980 (Aust.) S.128 and National Companies Act 1980 (Aust) S.229; Ontario Securities Act 1980 (Canada) S.74.

65. Companies Act 1955, S.195.

66. N.Z. Special Committee to Review the Companies Act 1973 (The MacArthur Committee Report) paras 312-315, which recommended legislative action against insider trading along the lines of the Australian Uniform Companies Act, §124 and 124A, but this recommendation has not been implemented.

67. See Howard Smith Ltd v. Ampol Petroleum Ltd [1974] AC 821.

68. See the cases cited in n.26 supra.

69. See the comments of Romer J. in Re City Equitable Fire Insurance Co.Ltd [1925] CR 407, at 427-30.

For a general discussion of the nature of fiduciary obligations see L.S. Sealy "The Director as Trustee" [1967] CLJ 83 at p.98. See also Sealy [1962] CLJ 69; [1963] CLJ 119 and Gareth Jones (1968) 84 LQR 472.

70. Regal (Hastings) v. Gulliver [1942] 1 All ER 378, at 389, 395; [1967] 2 AC 134 n, at 149, 159.

The mantle of fiduciary responsibility may also be worn by persons retained by the corporation such as accountants, lawyers or other advisors: Canadian Aero Services Ltd v. O'Malley [1974] 40 DLR (3d) 371.

71. Ibid, 395; 159 where Lord Porter said :

"It matters not that he could not have acquired the

property for the company itself - the profit which he makes is the company's even though the property by means of which he made it was not and could not have been acquired on its behalf".

72. Phipps v. Boardman [1967] 2 AC 46 at 89-91 per Viscount Dilhorne.

73. Trevor v. Whitworth (1887) 12 App.Cas 409; Heald v. O'Connor [1971] 1 WLR 497; Companies Act 1955 (N.Z.), S.62.

74. See Queensland Mines v. Hudson (1978) 18 ALR 1 at 4 where Lord Scarman, who delivered the judgment of the Privy Council, accepted the tests put forward in Regal (Hastings) supra, and Phipps supra, that there must be a "real sensible possibility of conflict" between the defendant's interest and the company's interest, and that the defendant (former managing director) could only exploit for himself the opportunity provided by the mining exploration licence obtained by him while managing director if he had the "informed consent" of Queensland Mines.

See also N.Z. Netherlands Society 'Oranje' Inc v. Kuys [1973] 1 WLR 1126, [1973] 2 All ER 1222, where the Privy Council upheld an agreement by the Society to release one of its officers from a fiduciary duty which he would otherwise owe.

75. Ibid. See also the remarks of Lord Hodson in Phipps, supra, at 105.

76. The Rule in Foss v. Harbottle (1843) 2 Hare 461, 67 ER 189 is likely to prevent such consent being a fraud on the minority since the consent is being given for an opportunity which is unable to be taken up by the corporation itself.

See also the recent case of Prudential Assurance Ltd v. Newman Industries Ltd [1981] 1 Ch 257, [1982] 1 All ER 354 (C.A.).

77. [1902] 2 Ch 421.

78. Ibid, at 426.

79. Idem.

80. Ibid at 426-427.

81. See for example, Green v. Charterhouse Group of Canada (1973) 2 O.R. 729.

82. (1914) 30 TLR 444 (P.C.).

83. Ibid, at 445.

84. [1977] 2 NZLR 225, [1977] 2 NZLR 298 (C.A.).

85. This is a similar approach to that of Lord Wilberforce in an opinion of the Privy Council in N.Z. Netherlands Society 'Oranje' Inc v. Kuys and the Windmill Post Ltd, supra n.74, also reported in [1973] 2 NZLR 163 at 166.

86. Supra, n.84 at 280.

87. Ibid, at 277.

88. Ibid, at 324-325.

89. Ibid, at 330.

For a discussion of the Coleman v. Myers case and its importance in the development of the regulation of insider trading see Rider "Percival v. Wright - Per Incuriam" (1978) 40 Mod LR 471, "A Special Relationship on the Special Facts" (1978) 41 Mod LR 585; F. Dawson (1979) 8 NZULR 256.

90. See the Listing Manual of the New Zealand Stock Exchange, August, 1981. See also the Sharebrokers Act 1908, S.11 which permits every registered stock exchange to "make rules for the conduct of the business of such exchange and the conduct of its members".

91. Ibid, para.501.

92. Ibid, paras 507, 508.

93. Ibid, para. 602.

94. Stock Exchange Guidelines for Securities Transactions by Directors of Companies issued in March, 1982 and available from the Stock Exchange Association. See also Duties and Responsibilities of New Zealand Company Directors (2nd edition) CCH, 1982, Auckland.

95. See the Introduction to the Guidelines, ibid.

96. Companies Act, S.195.

97. Stock Exchange Listing Requirement para 526.

98. See the discussion opposite n.109 infra.

99. [1959] AC 324, [1958] 3 All ER 66.

100. Ibid, at 366-367.

101. Companies Act 1955, S.209, 217.

102. Ibid, S.209.

103. Ibid, S.217.

104. See "The Bing Harris Report" loc. cit., n.2. at para. 29.8.

105. See the statement of Mr G.W. Valentine, Chairman of Bing Harris Ltd., ibid, at para.29.5.

See also an article by Mr Valentine in Company Director and Professional Administrator vol 17, n.170 August 1982 at p.29.

106. Salomon v. Salomon, supra n.56.

107. Supra, n.3.

108. Section 209(1) and (2) was substituted by the Companies Amendment Act 1980, which expanded the remedy in cases of oppression.

108A. See Nominee Shareholding in Public Companies - A Review of Law and Practice with a Proposal for Reform, June 1981 which is a discussion paper by the New Zealand Securities Commission. See also an article by D. Chaikin "Cracking the nominee in New Zealand" (1982) 8 Commonwealth Law Bulletin 814.

109. In Regal (Hastings) v. Gulliver, supra, n.70, the House of Lords accepted the chairman's lack of personal interest in the transaction as a 'complete answer'. Yet this was a classic case of tippee trading. He passed on the information to two companies, in both of which he was beneficially interested and a director. These two companies used the information to make a profit.

110. See In the matter of Cady, Roberts and Company (1961) 40 SEC 907, at 912.

111. For a discussion of Tippee Trading see the text opposite n.59 supra, and n.234 infra.

112. Sections 12, 13, 14 and 16.

113. Section 16.

114. This was defined in section 3a-7 of the Act to include "any director of a corporation, or any person performing similar functions to any organisation, whether incorporated or unincorporated".

115. In Rule 3b-2, the SEC has provided that the term 'officer' should be understood to comprehend 'a president, vice-president, treasurer, secretary, comptroller, and any other person who performs for the issuer, whether incorporated or not, functions corresponding to those performed'by such officers.

The five percent shareholding requirement was increased to ten percent in 1964.

116. This definition was extended in 1964 to include those people who hold positions in unlisted companies with assets of one million dollars and 500 shareholders.

117. The aforementioned estimate and this statement were stated in the Report of the Advisory Committee on Corporate Disclosure to the SEC 95th Cong. 1st Sess., Committee Print 95-29 (1977) at 620 et seq as quoted in Heller, "Chiarella, SEC Rule 14e-3 and Dirks: Fairness versus Economic Theory" loc. cit., n.34 at p.521.

118. The Australian industrial giant Broken Hill Proprietory Ltd (BHP) now releases a layperson's guide to the Annual Report. This is a good example of how the two objectives of disclosure: quantity and understandability, can be met.

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119. See discussion of Heller, loc. cit., n.34 at p.524 et seq.

120. This rule was made under S.10(b) of the Act.

121. Diamond v. Oreamuno (1969) 24 N.Y. (2d) 494, 248 N.E. (2d) 910. In this case, directors who sold their shares before information, unfavourable to the corporation, had become public knowledge, were held liable to account to the company.

122. E.g. Strong v. Repide (1909) 213 US 419, 431. This case concerned a company whose only assets were in the Phillipines. The defendant was general manager of the company and also owned 75 per cent of the shares in it. He bought shares from the plaintiff without disclosing the existence of negotiations with the Phillipines Government for the sale of the company's land. The price paid for the shares was only ten per cent of the value three months later when the land sale was completed. The Court found that the defendant had intentionally concealed his identify by acting through an agent, that the defendant managed the company alone and was in a position by virtue of his shareholding to ratify the sale, and on these bases held that

> "it became the duty of the defendant, acting in good faith, to state the facts before making the purchase."

123. E.g. Kansas, Georgia and Nebraska. Indeed it was observed by the Californian Court of Appeals that "the majority view... has become so eroded by exceptions and statements of fiduciary obligations in more recent decisions... that it can be said it no longer exists". Brown v. Halbert (1969) 76 Cal.Reptr 781, at 787-788.

124. Kardon v. National Gypsum Company (1946) 69 F.Supp 512, at 513.

125. Speed v. Transamerica Corporation (1951) 99 F.Supp. 808.

126. SEC v. Texas Gulf Sulphur (1968) 401 F. 2d 833.

127. In the Matter of Cady, Roberts and Co. (1961) 40 SEC 907; Texas Gulf Sulphur, ibid at 848.

128. Cady, Roberts ibid, at 912.

129. See Rider and Ffrench, The Regulation of Insider Trading op cit n.7 at pp 75-76.

130. Chiarella v. United States (1980) 445 U.S. 222.

131. Idem.

132. United States v. Newman F.2d (2d Cir October 30, 1981), unreported decision of the Court of Appeals. In this case, two employees of an investment banking firm were charged with misappropriating confidential information concerning proposed mergers and acquisitions which had been entrusted to them by the firm's corporate clients. The employees allegedly passed the information on to

Newman who in turn shared it with two others. The three then allegedly purchased securities in the companies that were the merger and takeover targets of the clients of the investment banking firm.

133. Ibid, at 5215.

134. The Newman decision has been applied by the District Court in New York to the case where the trader purchases options in another company. O'Connor & Associates v. Dean Witter Reynolds Inc et al Fed Sec L Rep (C.C.H.) para 92, 622 (1982). Thus, whilst the trader owes no fiduciary duty to the company whose shares (or options) he dealt in, he can come within the ambit of rule 10(b)-5 if he owes a fiduciary duty to his employers.

135. Texas Gulf Sulphur, supra n.126 at 848.

136. SEC v. Monash Fund (1979) 608 F.2d 938, 940-942.

137. Supra n.126, at 849.

138. Heller, loc cit n.34 at p.526.

139. See "Expanded Policy on Timely Disclosure" NYSE (1969) at A-19. as quoted in footnote 12 of Heller, ibid, at p.523.

140. Fed Sec L Rep (CCH) para. 82, 812 (1981).

141. Report of the Attorney-General's Committee on Securities Legislation in Ontario, March, 1965. (The Kimber Report).

142. Supra, n.76.

143. Ontario Securities Act 1966.

144. Ibid., section 109 (2)(a).

145. Section 1(7).

146. Section 1(6).

147. Section 110.

148. Section 111.

149. In Ontario Securities Commission Policy No. 3-24, 13 January 1972, it was said that there was an "apparently casual attitude taken by some insiders to their obligations "to report their transactions (quoted from Rider and Ffrench op.cit. n.7 at p.121).

150. See the Kimber Report, op.cit. n.141,at para 2.04.

151. Section 113(1).

152. Section 1(1)2.

153. See the Kimber Report, op.cit. n.141 at para 2.06.

154. Ibid, at para 2.09.

155. Section 113(1).

156. Section 114(1).

157. The words 'advantage received or receivable' in section 113(1) support this interpretation.

158. The only major case on the provisions is Green v. Charterhouse Group Canada Ltd, supra n.81.

159. The Securities Act 1980 (Ontario) came into force on August 1, 1981.

160. Ibid, s.74(1).

161. Section 1(1)21.

162. Section 74(2).

163. Section 74(3).

164. Section 76(1).

165. Section 118(1).

166. Section 123(1).

167. Section 1(1)21 Definition of "material change".

168. Supra, n.137.

169. Section 104.

170. Section 105.

171. Section 116.

172. Section 131 (1) and (2).

173. Section 131 (7)(a).

174. Section 1(2)(iv).

175. Section 1(2) and (3).

176. Section 131(7)(b).

177. Section 131(7)(c).

178. Section 131(1) and (2).

179. Section 131(4).

180. See text accompanying n.195 infra.

181. Section 126 of the Uniform Companies Act 1961.

182. Section 124(2).

183. Although a shareholder could bring a derivative action on behalf of the company, this was not attractive because of the possibility of incurring large amounts of costs and the

difficulties of proof associated with the very confusing language of section 124.

184. Victoria, New South Wales, South Australia and Queensland.

185. Section 6A of the Companies Act (NSW) as inserted by s.3 of the Companies Amendment Act 1971, no. 61.

186. Sections 69A to N, ibid.

187. Securities Industry Act (NSW) 1975, S.112(1); (Securities Industry Act 1980 (Commonwealth) S.128(1)).

188. Ibid, S.112(2); (S.128(2)).

189. Section 112 (3); (S.128(3)).

190. Section 112(5); (S.128(5)).

191. Section 112(4); (S.128(4)).

192. Section 112(8); (S.128(8)).

193. The word 'confidential' which appears in other legislatures (e.g. the U.S. and Canada) to describe information has been replaced by 'not generally available'. This was done to avoid any difficulties of proving that the information was given 'in confidence'.

194. Section 112(3)(b); (S.128(3)(b)).

195. Section 112(5)(b); (S.128(5)(b)).

196. Section 112(6) and (7); (S.128(6) and (7)).

197. Section 113; (S.129).

198. Section 114(1)(a),(b) and (c); (S.130(a),(b) and (c)).

199. Section 114(1)(a),(b) and (d); (S.130 (a),(b) and (d)).

200. Section 114(6); (S.130(6)).

201. See the sections in brackets ( ) above.

202. Securities Industry Act 1980 (Commonwealth), S.128(10).

203. National Companies Act 1980 (Commonwealth), S.229(3).

204. Idem.

205. It is thus a movement away from the doctrine of Percival v. Wright supra, n.77.

206. See Securities Industry Act 1980 (Commonwealth), S.128(1) and (2).

207. See Securities Act (1980) (Ontario), sections 131(1)(b), (2)(b) and (4)(b).

208. Supra n.76.

209. (1976) City Code on Takeovers and Mergers at p.4.

210. See Rule 73, Rules and Regulations of the Stock Exchange, concerning false markets.

211. See earlier discussion opposite n.95 supra, as to the importance of professional reputation and goodwill in the securities industry in New Zealand.

212. All dealers in securities other than those belonging to a recognised or exempted institution or association must obtain a licence.

213. E.g. Dexion-Comins International Ltd, Statement 25 April 1975, and Statement 8 May 1975; Ultra Electronic Holdings Ltd, Statement 22 September 1977 and 7 October 1977.

214. See Boots and House of Fraser case, Statement 23 July 1974, and Daily Mail, Times and Financial Times 24 July 1974.

215. Op.cit, n.94.

216. Practice Notes Council Statements, 71 Law Society's Gazette 395.

217. Idem.

218. This was contained in a letter written to Rider and Ffrench by the Secretary to the Institute of Chartered Accountants' Investigation Committees, as quoted in their book, op.cit. n.7 at p.171.

219. First published in 1973.

220. Companies Act 1967 (UK).

221. See Great Britain Board of Trade, Committee on Company Law Amendment (the Cohen Committee Report), Cmd 6659, para 86. Examples of this in operation are contained in "New Boss Quizzed on Insider Dealings" Daily Mail 23 August 1972; "Director's Sales Questioned" Guardian 13 June 1973.

222. Companies Act 1980 (UK), sections 68-74.

223. See "Insider Dealing: Guidance for Members following the Companies Act 1980" by the Institute of Directors (UK), at p.7. This is a summary of the effect of section 68(1), (2), (3), (4), (5), (6) and (7).

224. Section 68(1), (2).

225. Section 73(1).

226. Section 68(7).

227. Section 68(6).

228. Section 68(3). The onus of proof seems to rest on the prosecution or plaintiff to show that the tippee did have reasonable cause to believe.

229. Section 73(2).

230. Section 68(8)(a).

231. Section 72(1).

232. Section 70(2).

233. See the Bing Harris Report, op.cit. n.2 at pp 30-31 where the Chairman of the Securities Commission, who had discussed the operation of the new provisions with officers of the Council for the Securities Industry in London recently, reported that doubts had been expressed "that the new English laws were as efficacious in dealing with the problem as had been the previous machinery of self-regulation." Up until August 1981 the Panel had referred 13 cases, which they would previously have acted on, to the Board of Trade and none of them have been proceeded with.

234. See discussion in "Who is a corporate insider?" supra.

235. See BNZ Finance Annual Report 1981. The BNZ now holds 66 percent of BNZF issued capital. See Evening Post 6 September 1982, p.6.

236. See Evening Post 30 August 1982 at p.6. As a footnote, an assurance was given by the major shareholders at the general meeting that any price-sensitive information would not be used for the shareholder's own benefits. The three 'nominee' directors were elected to the board: The Evening Post 15 September 1982 at p.19.

237. See discussion under "Tippees", supra.

238. Supra, n.77.

239. Companies Act 1955, S.195 and Stock Exchange Listing Manual, para. 526.

240. Loc. cit. n.108A

241. Nominee Shareholdings-Draft Proposals for Legislation 20 March 1982.

242. Ibid, sections 88 and 89 of the draft amendments to the Securities Act.

243. Supra, n.93.

244. Jones v. Ahamanson & Co. (1969) 460 P.2d 464, 473.

245. Aharon Yoran "Insider Trading in England and Israel" (1972) Israel LR 215 and 373 at 221.

246. Coleman v. Myers, supra n.3 at 273.

247. Ebrahimi v. Westbourne Galleries Ltd [1973] AC 360 at 379.

248. In Coleman v. Myers, supra n.3, the judges of the Court of Appeal restricted the scope of the decision to the facts of the case: the closely held nature of the issuer, the dependence of the parties on the information, the relationship of confidence, the significance of the transaction and the degree of self-interest on the part of the respondents.

For a recent example of judicial attitudes to the scope of fiduciary duties see Law Society v Swain (unreported H.L.) reversing [1981] 3 All ER 797 (C.A.).

249. Supra n.76.

250. See the very recent statement of the English Court of Appeal in Prudential Assurance v. Newman (No.2) [1982] 1 All ER 354.

251. This approach is similar to that of Vinelott J. in Prudential Assurance (No.2) v Newman [1981] 1 Ch 257 which was rejected by the Court of Appeal, idem.

252. See Canadian Aero Service v. O'Malley (1973) 40 DLR (3d) 371 per Laskin J. at 384.

253. Supra n.248.

254. Supra n.250.

255. Some of those interviewed thought that the insiders must be confined to those who receive information which has a duty attached. On this basis they would not include tippees in their definition of insider. Others would not include brokers.

256. E.g. Coleman v. Myers supra n.3.

257. For instance Ontario, which originally only enacted civil liability for a limited class of insider, has now enacted criminal liability for a much wider class.

258. See L. Loss Securities Regulation Vol III p 1449 note 15 (derived from Rider and Ffrench supra n.7, footnote 293 at p.106).

259. Manne, "Insider Trading and the Law Professors" loc.cit. n.13 at p.553 et seq.

260. Op.cit. n.233 - for an example of what has happened in the United Kingdom.

Those interviewed included :

L.M. Papps:	Lawyer, Director of 25 public companies (12 as Chairman), Securities Commission member
I.L. McKay:	Lawyer, Director
P. Stannard:	Accountant, Professional Director, Securities Commission member
G. Hoskins:	Managing Director of Insurance Company
D. Whale:	Stockbroker
J. Aburn:	Stockbroker, Securities Commission member
G. Valentine:	Accountant, Chairman of Bing Harris, Vice-President of Institute of Directors
T. Beyer:	Chief Executive of Investment company, Director of Bing Harris, 'nominee' director of a number of firms
T. Doyle:	former Stockbroker, full-time Securities Commission member
B.K. Knowles:	General Manager of NZ Dairy Board, Director
D. Tudhope:	former Managing Director of Oil Company, now Professional Director
R. Bradshaw	former Accountant, now Professional Director

APPENDIX: QUESTIONNAIRE USED

1. CLASSIFICATION

Name:
Position that takes most of your time
Number of directorships
Number of Nominee or Representative directorships

2. REPRESENTATIVE DIRECTORS

(a) What do you see as the purpose of a dir who is appointed to the board of a company by a major shareholder - whether the s'h be a company or a person?

(b) (i) What do you see as the status of such a dir. (ii) Is he free to pass info on? (iii) With the consent of the bd? (iv) Does the type of information make any difference? - prejudicial, benefit, neither.

(c) What about in a take-over situation?

(d) Should the test of whether info should or should not be passed on be based on whether its benefits the coy or not?

(e) Is there any difference between a min controlling s'h and a maj controlling s'h?

3. INSIDE TRADERS

(a) What situations are there when the opportunity for it arises?
(it = insider trading)

(b) Immorality or Unfairness Aspect

(i) is the use of info that is not generally available what is unfair/immoral - if so, then is coy free to use its own info

(ii) should you be able to use someone else's info in all cases unless there is a negative reason, or, should you not be able to use it unless there is a positive reason? example

(iii) does it make any difference who approaches who

(iv) does it make any difference that the other person would have sold anyway - is there any difference betw. SE impersonal, and private dealings.

(c) Equality of Bargaining Position/opportunity

(i) to what extent is this an objective, is it realisable

(ii) Where should the line be drawn

(iii) Any difference between access, and analysis

(d) Efficiency

(i) The Price of Securities should reflect their "true" price if all info is known: Comment

(ii) It moves the price of securities in the right direction: Comment

(iii) How important is Efficiency as an objective of a securities mkt.

(e) Reward for Entrepreneur

(i) Give 3 examples - self-generated, intra coy, extra coy. of source of info.

(e) Personal Experience

(i) What types exist

(ii) What could happen, what has happened.

(iii) Current practice.

(iv) Size of the Problem

4. CONTROL

(a) Comment on existing Controls - Courts - Coleman v. Myers

- fiduciary duty - position of confidence
- SEA
- how adequate

(b) What principles should be followed - disclosure, prohibition

(c) Need for legislation

(i) How comprehensive

(ii) How wide defn of insider

(iii) How material must the info be, what price effect

(iv) is the "relevant" company to be limited to the coy of the insider e.g. offeree in a take-over situation.

(v) Any diff betw SE and face-to-face dealings

- caveat emptor, fraud

(iv) criterion/measure of liability

- personal loss
- Strict (based on Regal)
- implication if coys buy their own shares

(vii) Civil or Criminal Liab

(viii) Who should enforce

- Company
- Shareholders
- Affected party
- Securities Commission
- Police

(d) Is legislation going to leave us in a better position that we are now

(e) Is legislation capable of being adequately defined.

(f) Is legislation going to be capable of being enforced.

(i) Would it act as a deterrent

(ii) would it punish the honest

(iii) what would its effect be on public confidence in the market.

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426,388

Due	Borrower's Name
14/9/87	[illegible]
15/9/87	J. Campbe[illegible]
21/9/87	[illegible]
30-9-87	J. C. De[illegible]
26 JUN 1989	WCT
19/9/89	R. Lo[illegible]
20/3