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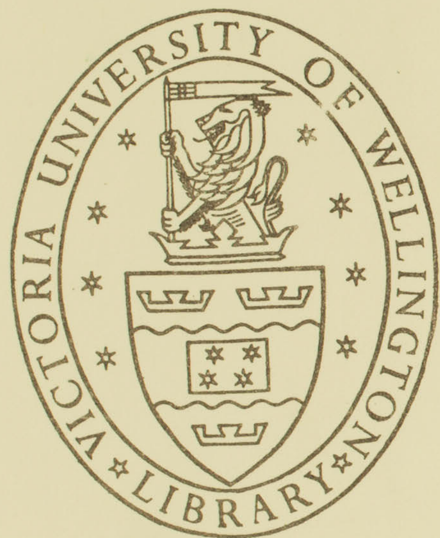
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INSIDER TRADING IN NEW ZEALAND: THE NEED FOR LEGISLATION

P. J. CARROLL

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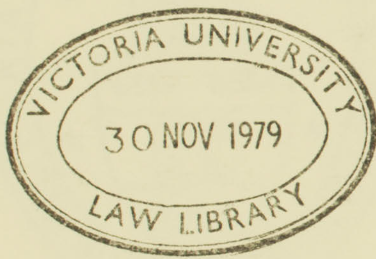

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INSIDER TRADING IN NEW ZEALAND: THE NEED FOR LEGISLATION

I. INTRODUCTION

The new Securities Commission is charged *inter alia* with keeping under review the law and practice relating to securities in New Zealand.[1] One of its early tasks will be to decide how it should deal with the problem of insider trading and whether or not it should recommend to Government the enactment of legislation to control or prevent it. Whatever decision it makes will undoubtedly provoke a storm of controversy within the commercial community and it will be a matter of considerable interest to spectators to see how this controversy resolves itself.

The problem of insider trading has attracted comprehensive legislative attention in many other countries including Australia, Canada the United States and the United Kingdom. (The U.K. legislation however was withdrawn prior to enactment). It has also attracted a high degree of controversy, with the result that it is perhaps unclear both if and to where we should move from our present position.

On the one hand, moralists argue that insider trading is a special kind of fraud and ought to be controlled by legislation. On the other hand however, realists insist on proof of harm or damage to outsiders and finding none, argue that the economic consequences of insider trading which may not be undesirable should dictate the issue of whether there is legislation or not. The rule caveat emptor they claim ought not to be lightly dismissed in arms length commercial transactions.

This paper examines the force of these opposing views in a New Zealand context and considers particularly the need for legislation in this area.

1. *Securities Act 1978 section 10.*

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Broadly insider trading arises whenever someone having confidential price sensitive information concerning a company's shares[2] trades in those shares for personal benefit with someone not having the same information.

The confidential information in question will usually be in the possession of the insider because of some connection which he has with the company in whose shares he deals (e.g. he might be a director, employee, or professional adviser to that company). He need not be one of these people however and someone is also an insider (a "tippee" to use the American expression) to whom information has been leaked by another insider. Insider trading covers both the situation where the information is favourable and shares are bought with a view to profit, and where the information is unfavourable and shares are sold to minimise losses.

There are at present in New Zealand no legal sanctions aimed specifically at discouraging insider trading or providing those affected by it with suitable remedies.[2a] However the rights of insiders to retain the benefits of insider trading are limited in some situations by the rules of equity and the common law. For

2, *Information is confidential if it has not been publicly disclosed; price sensitive if likely to materially affect the value of the shares when disclosure takes place.*

2(a) *In its 1978 code on takeovers the stock exchange purported to limit the rights of insiders (i.e. directors and advisers of a company) to engage in insider trading when armed with the knowledge of an undisclosed takeover bid. I do not regard these rules as significant for the purposes of this paper however for the reason that they appear to be "cosmetic" and nothing more. They do not bind directors in any way (only their companies); they cannot provide a remedy for someone who deals with an insider; and generally they cannot be enforced since there are no punitive sanctions. The stock exchange does reserve to itself the right to "suspend quotations" if insider trading is apparent, though it is hardly likely to do so since the persons most likely to be affected are the innocent majority of shareholders, not inside dealing directors or advisers, who will already have sold if the information is bad, or bought if it is good and be wanting to hold their shares until the information is made public. Predictably the rules have not yet been applied against insider trading - nor I suggest are they likely to be.*

example where there are personal relationships between the parties, deliberate or negligent misstatements, or some explicit or assumed fiduciary responsibilities the courts are able to apply a degree of felt morality to the transaction and provide those to whom the misstatements are made, or to whom duties of care are owed with suitable remedies and rights to recover losses. On the open market however where the parties will generally be dealing through agents, where they are at arms length, and where they are probably unaware of each other's identity there is little scope for equitable or common law rules to operate.

There is certainly no general duty for insiders such as directors (except in special circumstances) to disclose to someone with whom they trade material inside information which might affect that person's decision whether or not to trade at the price offered by the insider. It is trite that such a duty of disclosure could be imposed by an appropriate legislative provision, and a situation created in which an insider was prevented from trading in the event that he was unable or unwilling to disclose material inside information. Whether this should be done however is not quite so clear and is the principal issue with which this paper is concerned.

The Macarthur Committee's view on insider trading was that[3] -

> "Insider trading is inimical to a fair market in securities and results in a profit or other advantage by the employment of unconscionable methods."

3. *At paragraph 315.*

The Committee proposed legislation for New Zealand similar to ss.124 and 124A of the Uniform Companies Act enacted in Australia following the report of the Eggleston Committee. Briefly these provisions make insider trading by directors, officers and employees of a company subject to criminal penalties, with civil liability for recovery of inside profits where an outsider has suffered a loss by paying more for the shares than he would have done had he been aware of the inside information.

The Committee was obviously influenced by the moral and ethical aspects of insider trading. It did not consider the potential which presently exists for recovery from insiders, nor did it consider the numerous policy arguments for and against legislation, which in my view it should have done.

Traditionally the argument for legislation has been placed on the footing that it is unethical and unfair. The JUSTICE[4] Committee for example in its 1972 report on Insider Trading said:[5]

> "It is contrary to good business ethics that a man holding a position of trust in a company should use confidential information for his personal benefit .... Good business ethics should be supported and reinforced by legal sanctions."

Opposition to this view most often comes from those who look for some harm in the practice. One writer for example commenting on the JUSTICE report said:[6]

> "However much one may sympathise with the moral argument for imposing such an embargo [on insider trading] it must be admitted that some of the economic consequences may not be

4. *JUSTICE is the British Section of the International Commission of Jurists.*

5. *Paragraph 2.*

6. *Kay 36MLR 189 (1973).*

desirable ... [the point] is that it would be unwise to introduce a prohibition on insider trading before some attempt to prognasticate the economic repercussions of such a prohibition has been made."

It was submitted to the Macarthur Committee that insider trading was not a problem in New Zealand and that legislation was not therefore necessary to keep it under control. The Committee for reasons of its own however did not accept this submission. Nevertheless it is clear that the need for legislation is less strong in New Zealand and the insider abuses less obvious than for example in Australia in the late 1960s.[7] While there is no empirical evidence of the likely extent of insider trading in New Zealand it is probably less of a problem and the market generally less volatile than in other countries. Legislation therefore should be justified before it is enacted, in terms of a practical and a theoretical need.

The Committee I feel should have looked at the problem of insider trading in terms of:

(a) its present treatment at law;

(b) the need for legislation having regard to the likely extent of the problem and current academic controversy;

(c) the practicability of enforcement and the undesirable realities of partial enforcement.

Had it done so its conclusion may well have been different.

It is proposed to consider each of these issues.

7. *See Baxt "The Rae Report - Quo Vadis".*

II. THE PRESENT LAW

(a) Corporate recovery of inside profits

It is trite law that trustees, directors and others owing fiduciary duties may not use information for personal benefit which comes to them in their fiduciary capacity.[8] If they do then they are strictly liable to account in equity. In the context of recovery by a company of an insider's profit, this accountability could be based on a direct breach of the basic trust principle that "a person in a fiduciary capacity may not make a profit out of his trust;[9] on the fact of a conflict of interest; or on the basis that information, as property belonging to the company, may not be misused or misapplied by insiders without giving rise to liability for misappropriation of company assets.[10]

The duty to account for inside profits is not limited merely to directors of a company. It extends to its employees[11] and to tippees as well[12] provided that they knowingly and deliberately take advantage of the inside information for their personal benefit.[13] Their liability to the company can be based either on a direct involvement in a breach of a positive fiduciary duty as in Canadian Aero Services Ltd v. O'Malley[14] or as constructive

8. *This proposition is well established by cases such as G. E. Smith Ltd v. Smith [1952] NZLR 470; Regal (Hastings) Ltd v. Gulliver [1942] 1 All ER 378; Keech v. Sanford 25 ER 223; Cook v. Deeks [1916] 1 AC 554; Boardman v. Phipps [1967] 2 AC 48; Industrial Development Consultants v. Cooley [1972] 2 All ER 162; Abbey Glen Property Corp. v. Stumborg 85 DLR 3d 35; Queensland Mines Ltd v. Hudson [1978] 18 ALR 1. The proposition is fixed also in U.S. law e.g. Mosser v. Darrow 341 US 267, (1951); Diamond v. Oreomuno 248 NE 2d 910 (1968).*

9. *Per Lord Upjohn Boardman v. Phipps 1966 3 All ER 721, 751.*

10. *On information as company property see Boardman v. Phipps [1966] 3 All ER 721 Bell Houses Ltd v. City Wall Properties Ltd [1966] 2 Q B 656, Diamond v. Oreomuno 248 NE 2d 910, Peso Silver Mines Ltd v. Cropper 1966 58 DLR 1. Also Gower "Principles of Modern Company Law" (3rd edition) pp 555-56.*

11. *Seager v. Copydex Ltd [1967] 2 All ER 415.*

12. *Seager v. Copydex Ltd [1967] 2 All ER 415. Canadian Aero Services Ltd v. Omalley 40 DLR 3d 371.*

13. *See Competitive Insurance Co. v. Davies Investments Ltd 1975 1 WLR 1240,*

14. *40 DLR ed 371, also Schein v. Chasen 478 F 2d 817 (1973).*

trustees where the circumstances are such that they ought to have been aware of an involvement in a breach of such a duty.[15]

Viscount Sankey in Regal (Hastings) Ltd v. Gulliver[16] justified the rule for accountability when he said:

> "The general rule of equity is that no-one who has duties of a fiduciary nature to perform is allowed to enter into engagements in which he has or can have a personal interest conflicting with the interests of those he is bound to protect."

Admittedly in the context of insider trading the conflict is not readily apparent and may not even exist at all since a company is legally prevented from purchasing its own shares. Cases such as Boardman v. Phipps[17] and I.D.C. v. Cooley[18] however show clearly that proof of loss is not a condition precedent for fiduciary accountability. In Boardman a solicitor who acted for a family trust and one of the beneficiaries who acted with him were liable to account for the benefits received by them through the use of confidential information acquired whilst representing the interests of the trust. It was of no significance that the trust was unable to use the information itself. Similarly in Cooley a director was liable to account to his company for the profit made by personally undertaking a contract which would never have been awarded to the company.

15. *As for example in Selangor United Rubber Estates v. Craddock (No. 3) [1968] 2 All ER 1073, Karak Rubber Co. v. Burden (No. 2) [1972] 1 All ER 1210, Rowlandson v. National Westminster Bank [1978] 3 All ER 370.*

16. *[1942] 1 All ER 378, 381.*

17. *[1966] 3 All ER 721.*

18. *[1972] 2 All ER 162.*

In a Canadian case, Peso Silver Mines v. Cropper,[19] the court recognised the harshness of the rule and the seeming unjust enrichment of the cestui que trust which cases like Cooley, Boardman and Regal appear to countenance, and it was held that where a company decided in a bona fide exercise of its discretion not to proceed with a proposed development of a mining lease, two of its directors who subsequently undertook the development with their own resources were not liable to account for their profits. The case is clearly just on the facts though unfortunately contrary to general principles and the authorities. Much as its result may be desirable it is not likely to be followed in other commonwealth countries, or even in Canada following the recent case of Abbey Glen Property Corp v. Stumborg[20] [21]

The basis for the accountability appears to be not so much to award damages to the company for harms it has suffered, but rather to reimburse unauthorised and improperly taken profits.

In Diamond v. Oreomuno[22] an American court attempted to show corporate harm by insider trading by way of a "loss of public acceptance and marketability of its shares". The reasoning of the Diamond Court is not compelling however and seems not to have been accepted elsewhere or in other cases.[23]

19. [1966] 58 DLR 1.

20. 85 DLR 3d 35 (1978).

21. For a discussion of the Peso case see Gower pp 537-539, Beck "The Saga of Peso Silver Mines" (1971) 49 Can Bar Rev 80.

22. 248 NE 2d 910 (1968).

23. Though note Wright 1971 NZULR 209, 227 where it is suggested that the Diamond v. Oreomuno decision should "be accepted by our courts as expressing the correct modern view of the detrimental effects of insider trading on a company". I disagree with Mr Wright on this point.

An action for recovery may be commenced by the company itself[24] or by way of a shareholders derivative action should the company fail to act.[25]

(b) Shareholder recovery of insider profits

The extension of directors' and other insiders' fiduciary responsibilities to include shareholders simpliciter has hitherto been suppressed at common law by the single, much criticised decision of Swinfen Eady J in Percival v. Wright.[26]

This case is taken, except in special circumstances, to exclude the possibility of any civil action by an aggrieved shareholder who has sold shares to a director who knows that their value is likely to increase as a result of undisclosed inside information. It also precludes recovery by an external investor buying shares from an insider who knows that the value of those shares is likely to drop.

In Percival v. Wright directors had purchased shares from the plaintiffs without disclosing a possible takeover bid from another company. The bid eventually proved abortive but nevertheless the plaintiffs sought recission of the sale for a breach of fiduciary duty by the directors. This claim was denied however for the reason that such duties were owed by directors only to their companies, and not to individual members.

24. *Typical examples are Regal (Hastings) Ltd v. Gulliver 1942 1 All ER 378, Diamond v. Oreomuno (above).*

25. *E.g. Cook v. Deeks 1916 AC 554, Wallensteiner v. Moir 1974 3 All ER 217. See also Beck 52 Can Bar Rev 159 (1974), Wedderburn 1957 Camb LJ 194, Yoran 7 IS LR 217, 232. It is in this context that the issue whether information is corporate property or not is significant.*

26. *[1902] 2ch 421.*

In his judgment Swinfen Eady J said[27] -

> "The purchasing directors were under no obligation to disclose to their vendor shareholders the negotiations which eventually proved abortive. The contrary view would place directors in a most invidious position if they could not buy or sell shares, a premature disclosure of which might be against the best interests of the company."

It was obviously significant in the case that there was no question of unfair dealing and that it was the shareholders who had approached the directors, naming the price at which they wished to sell. These features of the case make it very similar to present day stock market transactions and it may be an argument against legislation in that context that few critics have suggested that Percival v. Wright did not do justice as between the parties on the particular facts involved.

The rule from Percival v. Wright however operates particularly harshly in the context of small closely held private companies, though equity and the common law have gone a considerable way toward mitigating this unfairness. Generally it will only be in the situations where there is insider trading simpliciter (i.e. no direct contract between buyer and seller) that an aggrieved

27. *[1902] 2ch 426*

Note that the "invidious position" to which Swinfen Eady J refers is exactly that created by Rule 10-B-5 in the U.S. Securities Act. Under this rule if company directors (or other insiders) have confidential information which they cannot or should not disclose, then they cannot trade either. If they do then they are liable to that person with whom they trade - Texas Gulf Sulphur Co. v. S.E.C. 394 US 976 (1969). The fallacy of Swinfen Eady J's logic seems to lie in the doubtful assumption that directors must be free to buy and sell shares at all times and that the secrecy of corporate information demands that no liability attaches to corporate insiders.

shareholder will be denied recovery from an insider under the rule. Whenever there are super-added fiduciary responsibilities or duties of care in the insider toward the person with whom he deals, as for example where they are dealing face to face, or where the insider misleads or misadvises, or exerts undue influence, there is considerable scope in equity and in tort for recovery by that person.

The special circumstances doctrine.

If, having regard to the special circumstances of a case directors (or other insiders) can by their conduct be regarded as having undertaken fiduciary responsibilities towards shareholders they will be liable to account for any profits if they fail to disclose material inside information. Decided cases indicate that fiduciary responsibilities will exist wherever there is actual or constructive fraud, undue influence, or conflicting self-interest in the insider vis-a-vis the person with whom he deals.

In Allen v. Hyatt[28] a Canadian case on appeal to the Privy Council, directors of a company were authorised as agents to negotiate a favourable amalgamation with another company and were given options to purchase shares at a fixed price. On the resale of those shares a substantial profit resulted which the directors resisted paying to the original shareholders on the basis of Percival v. Wright. The Privy Council took the view that in the circumstances the directors were acting as agents for the shareholders when they took the options: "The directors must have 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." They were held to be trustees of the profits for the shareholders.

28. *1914 30 TLR 444.*

In Nocton v. Lord Ashburton[29] a solicitor misadvising his client to release a security over land was in breach of an imposed fiduciary duty when it transpired that he had a personal interest in the release of that security which conflicted with that of his client. There was not actual fraud here: "Not moral fraud in the ordinary sense, but breach of the sort of obligation which is enforced by a court that from the beginning regarded itself as a court of conscience."[30] He was liable as a constructive trustee for his "constructive fraud". The court's reasoning is similar to that adopted by American courts in Strong v. Repide[31] and Taylor v. Wright.[32]

Transactions will also be set aside where one party has been induced to make the arrangement by someone exercising "undue influence" over him. In Lloyds Bank v. Bundy[33] for instance a guarantee and a legal charge over land were set aside because the guarantor placed reliance on his bank manager's advice. In the matter of a security taken by the bank, the bank manager was in breach of an imposed fiduciary duty by not ensuring that the customer took independent legal advice. The bank therefore was unable to retain the benefit of the transaction. Similarly in Tufton v. Sperni[34] the court set aside a contract for the sale of a house since the plaintiff reposed absolute confidence in the defendant because of their mutual involvement in a scheme to

29. *[1914] AC 932.*

30. *Per Viscount Haldane L.C. at p.954. Interestingly the measure of recovery in this case was the loss or harm caused to the client cf. Boardman v. Phipps Regal (Hastings) Ltd v. Gulliver, I.D.C. v. Cooley. Where the measure of recovery was the benefit obtained by the fiduciary.*

31. *(1909) 213 US 419.*

32. *(1945) 69 Cal App 2d 371. The common law in the United States however has been largely superseded by S.E.C. regulations and various "blue sky" securities laws in each of the states.*

33. *[1974] 3 All ER 757.*

34. *1952 2 TLR 516.*

benefit the Moslem religion. Evershed MR found there to be a breach of: "The duties of care and confidence which may be imposed ... as a result of the particular relationship which emerges from the special circumstances."[35]

The special circumstances doctrine was considered and applied recently by the Court of Appeal in Coleman v. Myers[36] where two directors in a closely held private company misled and misadvised shareholders in the context of a takeover bid, to accept a lower price for their shares than was appropriate. The directors failed to disclose material inside information to the shareholders with a resulting economic benefit to themselves. The issues before the court were:

(a) whether the directors owed any duties to the shareholders; and

(b) whether they were in breach of those duties in acting as they did.

At first instance Mahon J found that the directors did owe fiduciary duties to shareholders simpliciter, and he found Percival v. Wright to have been incorrectly decided.[37] He found however, that on the facts these duties had not been breached. The Court of Appeal[38] did not go this far however since it was not necessary for it to do so. Cooke J said[39] "In principle the case

35. *Ibid* 524.

36. 1977 2 NZLR 225.

37. pp 274-275.

38. Comprising Cooke, Woodhouse and Casey JJ.

39. At p. 340.

falls within the broad class of fiduciary relationships arising from special facts". This resulted he stated from:[40] "The family character of the company; the position of father and son in the company and in the family; their high degree of inside knowledge; and the way in which they went about the takeover and persuasion of shareholders."

The Court found the directors to be in breach of their responsibilities to the shareholders for a number of reasons. In particular they were obliged not to make statements on matters material to the sale which were deliberately or carelessly misleading. Moreover they were under a positive duty to disclose to the shareholders material information as to which they were aware the shareholders had no knowledge.

It was accepted that the directors, having decided to make a recommendation in terms of the Companies Amendment Act 1963 were under a positive duty of care to the shareholders. It was a significant feature of the case however that at least one member of the court[41] was prepared to find an alternative duty on the basis of Hedley Bryne v. Heller[42] and M.L.C. v. Evatt,[43 44] since the directors had financial interests in the transaction on which they gave advice. It had been suggested[45] that these cases would not apply against inside dealing directors. This view must now be doubted.[46]

40. *At p.330.*

41. *Cooke J at p.340.*

42. *1963 2 All ER 575.*

43. *1971 1 All ER 150 (161).*

44. *See discussion 1977 2 NZLR 340.*

45. *See Tom Hadden, "Company Law and Capitalism" (2 ed) 252.*

46. *The significance of this however may only be theoretical since it is difficult to imagine instances in which the tort will have been proved where there is not also fiduciary duties arising from special circumstances. There may be differences though in the measure of recovery in tort and in equity i.e. damages versus accountability for profits. The equitable remedy however is not a rigid one, e.g. Nocton v. Lord Ashburton [1914] AC 932 - recovery of losses suffered cf. Boardman v. Phipps, I.D.C. v. Cooley - repayment of profits.*

The Court of Appeal was obviously reluctant in this case to lay down any general test as to when fiduciary duties will arise in directors towards shareholders. Obviously however the "closeness" of the arrangement; the inequality of bargaining power; and the confidence reposed in the directors by the shareholders were particularly significant features. The court recognised the principle well established in other cases[47] that where one party to a transaction offers advice to the other he must ensure that the advice is not deliberately or negligently misleading or incorrect, and that it is honest. Moreover it was noted that the standard of conduct expected from directors could vary according to the circumstances: "in some cases it would be necessary to give an explicit warning and a great deal of information and in another there would be no duty to speak at all."[48]

Few can doubt that on the facts the decision in the case was just as between the parties involved. There are a number of specific difficulties which remain however and a number of matters which are still unresolved. The case has been criticised by several writers[49] and in particular exception may be taken to the court's treatment of the recission/damages issue and its treatment of Percival v. Wright.

With the greatest respect to the majority view on the question of damages or recission it is suggested that the view of Woodhouse J is to be preferred and that recission should have been granted. Both Cooke and Casey JJ thought in regard to the claims based on fraud, negligence and breach of duty that it would not be practically just to grant recission for the reason that "it would be flying in the face of commercial reality to suggest that returning shares to the appellants ... would be putting them back

47. *E.g. Gething v. Kilner 1972 1 All ER 166 - also Esso Petroleum Co. Ltd v. Mardon 1976 2 All ER 5.*

48. *Per Woodhouse J.*

49. *E.g. Rider 40 MLR, 41 MLR 585, Dawson 8 NZULR 256.*

in the same position as before they sold."[50] In one recent case however, English v. Dedham Vale Properties Ltd[51] the authorities relied upon by Cooke J as supporting his finding for recission were dismissed as being inconclusive on this point. Moreover one writer has questioned whether an award of damages is possible at all for the breach of a fiduciary duty:[52] "Certainly in its exclusive jurisdiction chancery did not award damages for breach of a fiduciary duty."

An important aspect of the case is that it recognised the breach of morality and ethics which had taken place. One of the factors cited by Cooke J as giving rise to a fiduciary duty was "The directors high degree of inside knowledge."

One writer has commented, and I agree that:[52]

> "Perhaps one of the most interesting elements in the Court of Appeal's judgment is the recognition of the special position of shareholders in small closely held companies and the intra-corporate relationship of confidence which may contribute to a finding of a special relationship in equity."

It is manifestly clear that the decision in Coleman v. Myers, like the decisions in Diamond v. Oreomuno[53] and Canadian Aero Services v. O'Malley[54] was an overt attempt by the Court to do justice as between the parties and to avoid the unjust enrichment of the directors to the direct and felt detriment of the shareholders.

50. *Per Casey J [1977] 2 NZLR 379.*

51. *[1978] 1 WLR 93.*

52. *Rider 41 MLR 588 (1978).*

53. *248 NE 910.*

54. *40 DLR 3d 371.*

The case will undoubtedly be of considerable significance in many subsequent cases of insider trading in shares in closely held private companies. It is unlikely however to have any impact in the context of stock exchange dealings where none of the special circumstances are present which were relied upon in Coleman v. Myers. Where for example the insider does not influence or induce the sale and where the parties are not dealing face to face it is difficult to envisage liability arising for insider trading. It is not clear however that it should. One group has suggested in the context of such dealings that:[55] "There are serious objections both practical and of equity to giving the other party to the contract a right of action. The practical objection is that the stock jobbing system makes it virtually impossible for any vendor to identify the purchaser and vice versa. The moral objection is that the matching of vendor and purchaser is entirely random and there is no obvious justification for giving a vendor who happens to have sold his shares to an insider a remedy which is not available to vendors who sold similar shares at the same time and at the same price to outsiders."

Before considering this however it is intended to briefly canvass the laws which have been enacted in other countries to deal with market transactions.

III THE LAW IN OTHER JURISDICTIONS

An increasing number of countries it seems are finding it necessary or desirable to limit the extent of market insider activities by specific legislative provisions purporting to prevent insider trading and imposing more severe duties of

55. *JUSTICE report at paragraph 2.*

disclosure on corporate insiders. I propose to consider briefly the extent of some of these provisions, their effect, and the market conditions which made them necessary. In particular the securities laws in the United States, Canada, Australia and the United Kingdom are of special significance in a New Zealand context because of the similarity of their general laws to our own.[56]

(a) The United States Provisions

Market insider activity is regulated in the United States by the Securities Exchange Act 1934. This is a comprehensive Act, part of Roosevelt's "new deal" for America, enacted following the economic crisis and the stock market collapse of 1928/29. Its ostensible purpose seems to have been to restore damaged investor confidence in the integrity and honesty of the stock market. Whether it was successful in this or not is not exactly clear.

Broadly, section 16(a) of the Act requires that details of share holdings and share dealings be filed with the S.E.C. by any officer or director of a company or by anyone holding more than 10% of any class of equity security of the company.[57] Section 16(b) provides that any profit made within a six month period by any one of these persons must be accounted for to the company whether or not there has been disclosure made under s.16(a) and whether or not there has been any misused inside information.

Recovery can be made by either the company itself or by any member of the company on its behalf if the insider does not voluntarily disgorge his profit.

56. *For a discussion of laws in other countries see for example Rider, 94 SALJ 437 (South Africa), 17 Malaya LR 310 (Hong Kong) 26 Int & Comp LQ 619 (France).*

57. *Cf. s.195 Companies Act 1955.*

Section 16 is open to several clear criticisms. It is arbitrary : the insider is liable even if he can show that there is no unfair misuse of information if he resells within six months at a profit. If he sells after six months however there is no liability even if he has clearly abused his inside position. There is no guarantee against evasion by "mutual back scratching" by insiders in different companies, or by trading through relatives and friends. Nor does it apply to tippees taking advantage of inside information.

Nevertheless it hits by and large the people who ought to be hit and it overcomes the problem of having to prove that an insider is trading on the basis of inside information. It generally restricts trading by those most likely to possess and to use inside information to long term dealings. It is a deterrent to insider trading more than anything else and even when a bona fide deal is caught by the section, the insider only loses his profit. There is no "penalty" imposed where there is no misuse of confidential information.

The scope and effect of section 16 is supplemented by Rule 10(b)5 of the Securities Act. This provides inter alia:

It shall be unlawful for any person directly or indirectly -

(1) To employ any device, scheme, or artifice to defraud;

(2) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make that statement not misleading;

(3) To engage in any act, practice or course of business which would operate as a fraud or deceit on any person.

This rule imposes a positive duty on an insider to publicly disclose material facts known to him by virtue of his inside position. If he cannot or should not disclose the information because of duties owed to his company then he should not trade either until public disclosure can be made : S.E.C. v. Texas Gulf Sulphur Co.[58] The duty applies both where the insider buys and sells shares:

> "It is almost true to say that sales and purchases by insiders have become contracts of the utmost good faith demanding disclosure of all material facts."[59]

An insider for the purposes of Rule 10(b)5 includes anyone who possesses inside information and is not limited to directors and management officers. It clearly includes tippees. Information is material if it might reasonably be expected to affect the market value of the shares and to influence investor decisions whether to buy or sell them.

The recipients of the disgorged profits under 10(b)5 are the affected shareholders who suffer a loss, not the company in whose shares the trading took place. In Texas Gulf Sulphur the problem of identification of those affected was overcome by the creation of an escrow fund of the disgorged profits against which all of the affected shareholders could claim.

(b) Australian Provisions

All States and Territories (except Tasmania) regulate the dealing in a company's shares by persons having an inside knowledge of

58. *1968 401 F. 2d 833.*

59. *Ibid at 857. Cf. the rule uberrimae fidei presently applicable to insurance contracts. Such positive duties to disclose material facts are unusual in commercial non-fiduciary situations.*

that company's affairs. There are presently two separate Acts which determine the extent of this regulation : the Uniform Companies Act[60] which closely follows the recommendations of the Eggleston Committee, and the Uniform Seçurities Industry Act 1975[61] which goes somewhat further.

Both Acts are a response to the highly volatile securities market in speculative mining companies in the late 1960s[62] and both recognise the principle established by the Eggleston Committee that:

> "... where [insiders] make improper use of confidential information the law should at least provide a penalty commensurate with the extent of the wrong committed."

They tackle this objective in different ways however.

On the one hand sections 124 and 124A of the <u>Uniform Companies Act</u> impose both civil and criminal penalties upon any officer of a company (i.e. a director, secretary or employee) who makes improper use of information acquired by virtue of his position to gain an advantage for himself or for any other person. Broadly the provisions make an insider liable for loss suffered by a person to whom he <u>sells</u> shares if the other pays more for them than he would have paid if the information had been publicly known. A tippee is <u>not</u> an insider for the purposes of this Act, though in line with the Eggleston Committee's recommendations the officer of the company involved is liable to the outsider with whom the tippee traded.[63] An inside dealing company officer is

60. *In force in S.A., N.T., A.C.T.*

61. *In force in N.S.W., Qld, Vic., W.A.*

62. *See R. Baxt "The Rae Report - Quo Vadis".*

63. *The Committee noted: "We see no good reason why an officer who misuses confidential information by telling his friends to sell should not be liable to those who bought from those friends."*

also liable under the Act, on conviction, to a fine not exceeding $2,000. For information to fall within the provisions it must be specific; confidential and material (market-wise).[64]

On the other hand section 112 of the Securities Industries Act 1975 provides inter alia that:

> "... a person who is, or at any time in the preceding six months has been, connected with a body corporate shall not deal in any securities of that body corporate if by reason of [the connection] he is in possession of information that is not generally available but, if it were, would be likely to materially affect the price of those securities."

This prohibits all dealing in a company's shares by an insider[65] until the price sensitive information becomes publicly known. In addition, unlike the Uniform Companies Act, it applies both to where the insider buys and sells shares on the basis of confidential information. The prohibition on trading also extends toward shares in other companies in relation to which the insider gets information by reason of his position.[66] A tippee is treated for the purposes of the Act as an insider[67] and tipping is made an offence.[68]

The sanctions against insider trading are civil liability to the outsider to the extent of the profit made; accountability to the company for profits taken; and criminal liability involving a fine not exceeding $10,000 or imprisonment.[69] [70]

64. *Note Ryan v. Triguboff [1976] 1 NSWLR 588.*

65. *Defined later in the section to include officers, directors, employees, professional advisers and substantial shareholders (more than 10%) of the company) (s.112(8)).*

66. *Section 112(2).*

67. *Section 112(3).*

68. *Section 112(5).*

69. *Sections 113 and 114.*

70. *The Uniform Securities Industries Act 1975 is closely modelled on the U.K. Companies Bill introduced by the Heath Government in 1973 and revived in*

(c) Canadian Provisions

Provisions purporting to deal with insider trading are contained in the Securities Acts of Alberta, Manitoba, Ontario, British Columbia and Saskatchewan. Section 113 of the Ontario statute which is typical of the others provides inter alia:

> "Every insider of a corporation or associate ... of such insider who ... makes use of any specific confidential information for his own benefit or advantage ... is liable to compensate any person or company for any direct loss suffered ... as a result ... unless [the] information was known or ought reasonably to have been known to [that] person ... at the time of the transaction ...."

The law is very similar to and has developed from the United States provisions. It applies to all corporate insiders (directors, employees, advisers etc.) and to their affiliates or associates (tippees). To give rise to liability the information complained of must be "specific confidential information" which the insider makes use of for his own benefit.[71] The information must also be such as would, if generally known, materially affect the value of the securities.

1978. It is comprehensive and the penalties are severe. As yet there are no reported decisions on the Act which is perhaps in itself comment on the provisions and the likely effect which they will have. It is not yet clear however just how the Act has affected the securities market nor whether it has prevented insider trading or merely encouraged those engaging in it to seek less detectable methods.

71. *Note the case of Green v. Charterhouse Corporation 1973 2 O.R. 677 on the meaning of "specific confidential information" - also Ryan v. Triguboff [1976] 1 NSWLR 588. See also S. R. Bailey ABLR 272-274.*

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Liability of insiders for insider trading is solely to the person from whom the shares are purchased or sold, or to the company in relation to which the person involved stands as insider.

In Ontario at least,[72] there must also be extensive monthly disclosure of changes in beneficial shareholdings and share dealings by all insiders of a company including its directors, senior officers, each of the five highest paid employees, and officers of companies which are themselves insiders of that company.[73]

It is not clear how effective the Canadian provisions are or what the market conditions were which made them necessary. Nor is it clear the extent to which they are enforced. As in Australia, there have been very few reported cases on the operation of the provisions.

(d) <u>United Kingdom Provisions</u>

Bills to implement controls on market insider trading were introduced in the United Kingdom in 1973 and 1978. They were drafted consequent to the report of the Jenkins Committee and to two white papers - "The conduct of company directors";[74] and "changes in company law".[75] Unfortunately, for reasons political neither bill was enacted into law.

72. *I have no information on the other states.*

73. *See Ontario stock exchange rules on disclosure of beneficial interests.*

74. *CMMD 7037.*

75. *CMMD 7291.*

They were however to have contained a prohibition on insider trading in a company's shares by anyone connected with it during the preceding six months who was in possession of material inside information, and a prohibition on dealing by tippees who obtained information from one of those persons. "Connected person" was defined in the 1978 Bill as meaning an officer or employee of the issuer of the shares or a related company or any person who occupied a position which might reasonably be expected to have given him access to inside information. Inside information was information which (a) was not generally available; and (b) would if it were so available be likely to materially affect the price of those securities.

The bill was aimed solely at market dealings or private dealings in listed securities and it was very comprehensive. It proposed both criminal and civil penalties for persons guilty of insider trading. The criminal penalty was to be a fine of up to $2,000 and imprisonment. The civil penalty was to involve that the undisclosed inside information be treated as a fraudulent misrepresentation giving rise to appropriate remedies in damages or recission. The legislation generally was to replace the existing body of legal and extra-legal rules existing in Britain.[76] [77]

IV WHY REGULATE FOR MARKET INSIDER ACTIVITIES IN NEW ZEALAND?

Where the parties to a securities transaction are dealing on the open market either at arms length as strangers or through an intermediary such as a stock broker it is manifestly clear that

76. *See Misrepresentation Act 1967; Regulations of the London Stock Exchange Prevention of Fraud (Investments) Act 1958; City Code on Takeovers and Mergers (1969); Protection of Depositors Act 1963; Companies Act 1967.*

77. *For a detailed discussion of the terms of the 1978 Bill see: Walmsley NLJ January 1978 p.15, October 1978, 1051, Rider NLJ December 1978 1236.*

the law presently provides no remedy if one of them is motivated to trade by material inside information which he does not disclose to the other. To avoid liability a market insider has only to avoid making material misrepresentations or misstatements of fact. He is under no positive duty as well toward the other party to disclose material facts.

As can be seen from the above discussion however, it is the principle purpose of anti-insider trading legislation to impose such a duty on him and render him liable in the event that he does not disclose.

This would appear to be out of line with normally accepted rules of practice in commercial non-fiduciary situations and whether it should be done therefore should depend upon clear proof of necessity in the specific context in which it is sought to be imposed. In the context of the New Zealand securities market it is my view that this proof is difficult to sustain and that the presumption, on balance, should be in favour of the status quo.

(a) Policy Bases for a Ban on Market Insider Trading

There is presently a diversity of academic opinion on the need to outlaw insider trading and the basis on which this should be done. The principal argument advanced in favour of such a ban is that insider trading is unethical and dishonest and ought not to go unchecked. Other arguments stress its unfairness and the need for market dealings to take place from an initial point of equality, and the need to promote investor confidence in the integrity of the market in order to encourage people to invest. None of these arguments however are particularly compelling.

(i) Market morality

It is clear in other commercial situations that legislation is presently in force which imposes certain minimum standards of conduct on parties to a transaction in which one of them, by reason of his relative bargaining strength, could be in a position to act oppresively and for his personal benefit to the corresponding detriment of the other. Tenancy laws,[78] insurance laws,[79] various consumer laws[80] and laws relating to carriage[81] are but a few examples and by analogy those opposed to insider trading claim legislation would also be appropriate to establish certain minimum standards of conduct for directors and others who misuse the confidence of their positions for purely personal reasons.

Moral opposition to insider trading in market situations rests on two principle elements: first 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. The argument for legislation in this context is initially an attractive one since it is clear that the conduct of many insiders, though not sufficiently serious to constitute fraud, is not entirely able to be justified on an ethical basis.

78. *E.g. Property Law Act 1952.*

79. *E.g. Life Insurance Act 1908, Insurance Law Reform Act 1977.*

80. *E.g. Sale of Goods Act 1908, Chattels Transfer Act 1924, Minors Contracts Act 1967, Money Lenders Act 1908.*

81. *E.g. Carriage of Goods Bill 1979.*

Traditionally however the government has been reluctant to interfere in strictly commercial matters knowing that if it does, business profitability and economic growth will suffer. Anti insider trading legislation is clearly in the nature of a consumer confidence and protection measure, and the issue whether to legislate on a moral basis relates solely to whether there is a need to do so. In my view there is not. A large proportion of the investment in equity shares is by institutional investors and few would suggest for example that an insurance company or a bank would need protection from the market activities of a single unscrupulous insider. In relation to the individual market investor the argument has considerable force that if he is foolish enough to enter a lions den he deserves to be eaten, particularly since he does not really suffer a "loss" of anything which could be regarded as his property.

While a shareholder who deals with an insider may justifiably have a sense of grievance because of the ethical doubts concerning the misuse of confidential information, there is no way in which this sense of grievance can be translated into a justification for allowing him to recover to the extent of that insider's profit. As the Justice Report on insider trading stated:[83]

> "when a director buys on the market in the knowledge of a forthcoming bid for the company, the seller of shares would probably have put his shares up for sale anyway and the price he gets may have been slightly raised by the fact that the director is in the market as a buyer ... the matching of vendor and purchaser is entirely random and there is no obvious justification for giving a vendor who happens to have sold shares to an insider a remedy which is not available to the vendors who sold at the same price to outsiders."

83. *Paragraph 2.*

The Justice Report recommended instead that criminal penalties be imposed, but with respect this approach is somewhat question begging. If it is accepted that insider trading is not fraud, that the insider in no way induces the sale, and that it in no case causes actual loss to the outsider, it is difficult to sustain an argument for legislation at all. Some attempts have been made to establish a harm which is directly attritutable to insider trading, without however a great deal of success.[84] Professor H. G. Manne, one of the principal opponents of legislation has claimed that the moral argument for a ban on insider trading is "self-righteous", "question begging", and "hypocrisy".[85] He states that:

> "Carried into the arena of serious debate on public policy, moral arguments are frequently either sham or a refuge for the intellectually bankrupt. Just because the phrase "insider trading" raises a spector of dishonesty and fraud exploitation and greed is not sufficient basis for assuming that fact must be so or that the practice must, ipso facto, be outlawed."[86]

He disposes of the moral approach by insisting on proof of damage and he makes a number of significant points. The first is that only an extremely small fraction of the total number of shares are actively traded[87] and of these, only a very few will be influenced by one of the parties having access to confidential

84. *Painter Federal regulation of Insider trading (1968) 555, Schotland (1969) 53 Va LR 1447-48, Mendelson 1969 117 U. Penn LR 473. Note also in* *Diamond v. Oreomuno 248 NE 2d 910 the attempt by the court to show corporate harm through insider trading by way of loss of "public acceptance and marketability of the shares."*

85. *1966 Harv. Bus. Rev. 113.*

86. *Vand LR 1970 23: 549.*

87. *0.27% per week in the U.S.*

inside information: "The absolute odds in favour of [the average investor] losing anything as a result of insider trading are so small as to be unworthy of serious concern."[88] The second point is that the outsider might even benefit from the presence of the insider in the market.[89] And the third is that shareholders who do not trade in the pre-disclosure period are not harmed since they will ultimately benefit from the increased value of the shares.

A further argument opposed to "consumer" legislation in what is essentially a commercial situation is that it could be regarded as the "thin edge of the wedge" leading to wider and more extensive regulation of business and related activities. It is ironic for instance that under the United States laws Texas Gulf Sulphur Co. officials buying stock with knowledge of a new mineral strike have done something immoral for which they must be punished, but that the company itself buying surrounding land from the unknowing owners, using precisely the same information, has merely performed in a business-like manner and displayed considerable acumen.[90]

It would be difficult to justify a similar situation being created in New Zealand without some clear necessity for it.

(ii) Market Egalitarianism

Criticism of insider market activity derives some force from the view that it is not "fair" to others dealing on the market to have insiders trading on the basis of confidential information which

88. *Insider trading and the Stock Market 1966 p.91.*

89. *Either as a buyer or seller simpliciter or because they may be prepared to pay more, or accept less for the shares than would an outsider.*

90. *While condemning the actions of the insiders, the court of appeals actually condoned the company's motives for delaying disclosure "a valuable corporate purpose was served by delaying the publication of the K-55-1 discovery". 401 F 2d 833, 850.*

they do not disclose. There are some who claim that parties dealing with each other on the market should deal from an initial position of equality and that the profit or loss from a securities transaction should be governed by the parties' market judgment rather than by access of one of them to material inside information.

This sportsman's theory of the market requires that as far as possible trading in shares should be on the basis of an informed assessment of their worth and that the odds be the same for all who play the game. This will not be possible if only one party has access to certain relevant data and it is unfair not only because the other party has not got it, but that he cannot obtain it at all.

This argument is generally categorised as one for "market egalitarianism" and, as a policy basis for a ban on insider trading it has been relied upon by a number of writers.[91] As a general theory however it is somewhat dampened by the fact that carried to its logical extreme it "would eliminate the use of all "informational" advantages" and would require that "parties to a transaction must under all circumstances inform each other of all material facts which they know, or should know are not known by the other party and are not publicly available."[92]

In addition it would be commercially naive to justify proscribing insider trading on this basis since in most commercial transactions involving speculative or investment purchases almost no-one discloses to the other party his true reasons for dealing and no-one has yet suggested that they should. The rule uberrimae fidei has a very limited application in commercial

91. *E.g. Rider and French 95 SALJ 79 (1978); White, (1974) 90 LQR 494.*

92. *D. D. Prentice 1975 CLP 92.*

dealings generally[93] and it is difficult to sustain an argument that a statutory form of the rule should apply to contracts for the sale of securities where there is little actual harm, but not apply in situations where loss is more easily shown.[94]

(iii) Investor Confidence

It is another argument often made in favour of a ban on insider trading that investors and potential investors will channel their funds in other directions than the share market unless they are assured by a plethora of regulations that the integrity and the honesty of the market are assured, and that they will not be taken advantage of by unscrupulous insiders.

Professor Loss, the author of the standard text on United States Securities laws has said:[95]

> "Although insider trading on undisclosed information may not present a threat of the same magnitude as market manipulation in the sense that the former practice does tend marginally to force the price in the same direction, it 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 investors' confidence that current quotations accurately reflect the objective value of his investment."

93. *I.e. it applies to contracts of insurance and almost nowhere else in the absence of fiduciary obligations. See Spencer Bower on actionable non-disclosure.*

94. *E.g. in Texas Gulf Sulphur, the buying of the land surrounding the mineral find. It was the company itself here which approached the surrounding land owners. Cf. the stock market where an outsider's decision to sell is formed independently of any other person's decision to buy and where there is no contact made between the parties.*

95. *(1970) 33 MLR 36.*

In my view the accuracy of this supposition is questionable. One writer has said:[96]

> "It is also hard to take this argument very seriously. Individual investor motivation is complex and factors other than consciousness of relative access to knowledge usually determine the small investors presence in or absence from the market. Increasingly the small investor is using institutional intermediaries, and his recognition of a knowledge disadvantage might simply accelerate this tendency rather than push him out of the market altogether."

I agree. Public confidence in the market depends on a large number of psychological and economic factors. The fact that insider trading is taking place would have a very limited effect on this confidence.

Moreover, where anti insider trading legislation has been enacted there is no evidence that it has had the effect of drawing further investment and investors into the market.

(b) Why not preserve the status quo?

Aside from the fact that ultimately there is no loss caused to outsiders by insider trading there are a number of affirmative arguments which may indicate that it may be preferable not to initiate legislation to proscribe it.

In the first place, the economic consequences of insider trading may not be wholly undesirable; second, the defects of the present situation may be outweighed by the disadvantages of legislation;

96. *Herman 2 1 U.C.L.A.L.R. 17. Cf. Rider and French 95 SALJ 96.*

and third, the practical imperfections of legislation, the difficulties of enforcement, and the problems of definition may make it unreasonable to regulate for something which in the view of those most closely associated with it, is not a problem at all.[97]

(i) Stock Market Efficiency

It appears to be commonly accepted that insider trading in the market tends to push share prices in the right direction and toward the levels at which they should stand, before they would otherwise move[98] and by so doing, makes the market more efficient. There is controversy however on whether this is a plus or a minus on the issue of legislation.

One view is that the more efficiently the stock market functions the better off everyone is for a number of reasons. One is that capital will be allocated to its highest return uses;[99] another that violent market fluctuations will be diminished; and further that there will be continuity in price levels because insiders by making use of their special information (buying when share prices are declining without cause, and selling when they are artificially high) will provide the extra market force needed to cause a gradual levelling off of fluctuations. It is also argued that an efficient market is to be preferred to a fair one and encourages investor participation since it enables investors to verify that the market value of the shares is near to their true value.[100]

97. *Macarthur report paragraph 312, submission from the New Zealand Stock Exchange Association.*

98. *Manne 1970 23 Vand LR 563, Loss, 1970 33 MLR 36, Rider and French 95 SALJ 93-94.*

99. *Manne 1970 23 Vand LR 561-566 "The price of a company's stock is the best indicator of the performance record of existing management and the potential profitability of a takeover."*

100. *This is because transactions based on insider information draw other transactions towards them, and formerly random transactions are drawn towards correct levels.*

The opposing view is that insider trading only has a tendency to make the market more efficient; it does not actually have the effect of making it so. As the few empirical studies which have been made show (and as Manne himself admits) the level of insider market activity is very low in relation to the total number of shares and share market transactions, and it appears that insider trading has no significant impact on market prices.[101] Thus the claimed benefits may be more imaginary and theoretical than borne out in practice.

In addition the claim that investors will be more attracted to an efficient market than a fair one is disputed. It is generally agreed that public confidence is the prime requirement for an effective stock market since if the investor loses confidence he will not invest, with the result that companies will not get capital. It is not agreed that this effectiveness is promoted by allowing insider trading to continue unfettered. "Markets, like the law, must seem to do equity. Otherwise the public will lose faith in them." Insider trading and market manipulation it is claimed go hand in hand.[102] The investor it is claimed should be able to be certain that the basis of every decision of managers is the interest of the company: "If the way were open to managers to profit themselves by their decisions there would be an undesirable effect on the mind of the shareholders. Again fairness must be seen to be done."[103]

101. *Rider and French 95 SALJ 95 referring to empirical studies by Wv (1963) and Fischer (1965).*

102. *Rider and French 95 SALJ 97. Note however Manne 1970 23 Vand LR 575. He agrees that market manipulation ought to be prevented for the reason that it does add a high cost to the functioning of the market. He claims however that market manipulation differs from insider trading just as a reliable tip on a horse differs from having a race "fixed". He says "If all insider trading could be effectively prevented there would probably be no fraudulent manipulation of stock prices either. But that does not decide the underlying issue about insider trading .... After all, outlawing horse racing is the surest method of preventing fixed races."*

103. *95 SALJ 97.*

There is considerable force in both of these two conflicting views. The resolution of the differences between them would seem to require more empirical research into individual investor motivation and the source of investor market confidence has been done.

(iii) Reward for Entrepreneurs

One of the more controversial arguments in favour of allowing insider trading is that it is an appropriate way in which to reward entrepreneurial activity in large corporations.

According to Professor Manne entrepreneurial activity is essential for the growth of business and the economy. Hence entrepreneurial talents ought to be developed and promoted by allowing entrepreneurs to materially profit in direct proportion to the extent of their efforts: "Entrepreneurial activity produces the kind of good news to which the market prices respond. Hence the creator of good news who must inevitably know about it first is ideally situated to make a profit in the market from what he knows. Under ideal circumstances at least, insider trading thus has the advantage of tying the entrepreneurs reward directly to his contribution."[104]

This proposal to allow entrepreneurs to engage in insider trading has drawn an angry and adverse response from many quarters. It is one argument put that the entrepreneurial talent has already been brought and paid for by the corporation[105] and another that the extent of the entrepreneurs profit is not the measure of his

104. *Heatherington 1967 Wisconsin LR 726. Restating Manne's arguments.*

105. *Ibid at 727. For a discussion of who is an entrepreneur see also Mendelson 1969 117 U. Penn LR 487.*

talent but rather the extent of his resources and the number of shares which they will enable him to buy. Moreover it is clear that many people who are in a position to benefit from insider trading are not entrepreneurs. For example it is difficult to see why many of the employees of Texas Gulf Sulphur Co., or why others who might have inside information such as lawyers, bankers, or investment brokers should be entitled to entrepreneurial reward.

Professor Manne observes however that the occasions when insiders get returns to which they are not entitled by trading on inside information, may balance those when they fail to get rewards to which they are entitled. He argues as well that allowing entrepreneurs to profit in this manner will relieve companies of the obligation to pay for these specialised kind of entrepreneurial talents and may serve to attract into management positions those who would otherwise be unwilling to act in a managerial capacity.

His argument is certainly not conclusive in favour of not having legislation. It is one factor which must be considered, however, that one of the results of this may be that companies and their shareholders profit thereby.[106]

(iv) The realities of partial enforcement

A further argument is made that the realities of legislation and the problem of resources for investigation and prosecution of insider abuses mitigates strongly in favour of the status quo. It is clear that in order to control insider trading it would not be sufficient merely to enact legislation outlawing it, there must

106. *Via the profitability for the company of entrepreneurial activity by its employees, and the direct savings resulting if material benefit for the exercise of entrepreneurial talents comes from sources outside of the company.*

also be an effective method of enforcing this law and it is a sad fact of government that far too often with similar legislative provisions, there are insufficient resources made available for effective enforcement commensurate to the size of the problem. Decisions would have to be made about where limited resources should be applied and enforcement may become both arbitrary and discriminatory.

It would be impossible to prevent insider abuses altogether, they are too elusive and the potential for them in the stock market structure far too wide to permit full detection and adequate control. All that legislation may do is place a premium on innovation and the ability to conceal interests in transactions in such a way as to avoid the attention of the enforcement agency.

It must at least be asked in these circumstances whether the government should attempt to validate a myth of equal investor opportunity when it would be little more than a legislative deception of the public.

It has been argued that the function of the legislation is to inspire market confidence in intrepid investors, thus causing them to make further investments and to this end, it does not matter that the legislation is only "cosmetic" and incapable of complete enforcement. One must seriously doubt the validity of this argument however in terms of legislative policy and the philosophy of government intervention in private sector activities.

I have suggested above that insider trading has only a tangential bearing if any at all, on individual investor confidence in the market. It is difficult to see that this confidence would be increased by "cosmetic" legislation which was incapable of effectively proscribing insider trading. Quite the reverse in fact. It is

suggested that if legislation was enacted it would serve only to focus attention on the practice and thus damage the protective cocoon of obscurity and lack of knowledge which presently exists in the minds of many market investors. In addition if legislation was to be enacted similar to that in force elsewhere it may pave the way for greater investor insecurity in the market than presently exists. In just the same way that shareholders' confidence in the ability of the present law to control the activities of errant directors would have been shaken by the result of the recent criminal prosecution of the J.B.L. directors, so too would the result in cases such as Green v. Charterhouse Corporation[107] and Ryan v. Triguboff[108] fail to inspire investor confidence in the honesty of the market and the integrity of the legislation.

V. CONCLUSION

It is important to bear in mind that the decision whether or not to legislate for insider trading involves nothing more than a value judgment involving weighing up the relative merits of outlawing something which appears unethical, dishonest, and seems to involve unjust enrichment of an insider, against the disadvantage of creating legislation which can never be fully enforced, will possibly not enure to the benefit of any individual, or to business generally, and which may not even be necessary at all. It may be that the validity of this decision would be incapable of being verified by empirical or statistical research.

107. (1973) 35 DLR 3d 161 affirmed (1976) 68 DLR.

108. 1976 1 NSWLR.

While legal restraints on the misuse of inside information are possibly very desirable, largely on equity grounds, it must also be recognised that it will be impossible to curb insider abuses entirely. It is clear from the above discussion that the problem in the context of face to face transactions is already adequately provided for at common law following Coleman v. Myers[109] and that vis-a-vis the company to whom insiders owe fiduciary responsibilities the balance is more than adequate in favour of the company - perhaps even to much so bearing in mind that the company is unable to have a financial interest in dealings in its own shares. The dilemma of legislation therefore exists solely in the context of market activities.

The argument may be made that outlawing insider trading will cause companies to make public disclosure of information at an earlier time than they otherwise would. This ignores however that a legitimate corporate purpose may be served by delaying disclosure[110] and that in fact, as in Percival v. Wright, untimely disclosure of information which subsequently proves abortive may work to the detriment of those who buy or sell on the strength of it.

The argument may also be made that the moral imperative of insider trading demands legislation purporting to prevent it. Against this however must be balanced the legislative inertia in favour of the status quo absent proof of necessity and in this case absent proof of damage. Whether as a matter of accident or deliberate public policy, it is clear that legislation is not usually enacted unnecessarily, and where it is unnecessary it should be repealed. The onus of proof therefore in this situation undoubtedly lies with the proponents of legislation to show why it is needed, rather than with opponents to show why it is not.

109. [1977] 2 NZLR 225.

110. *E.g. if disclosure had been made by Texas Gulf Sulphur it would have lost its advantage in negotiations with owners of land surrounding the TGS strike. The Court recognised delay here as a legitimate corporate purpose (401 F. 2d 833, 850).*

The moral imperitive against legislation is clearly stronger in the case where an insider sells shares knowing that their value is to drop than where he buys them knowing that the price is likely to rise. In my view the arguments made for and against legislation hold good in both cases, namely that the outsider would have bought or sold the shares irrespective of whether the insider was dealing in the market and therefore ought to be denied recovery, but it may be that if we are to enact legislation at all it should be done in line with the recommendation of the Macarthur Committee and provide for recovery only when shares are sold by an insider which subsequently drop in value. Equity would certainly favour such a result, and investor confidence as well may be strengthened if investors realise that although recovery will be precluded of "lost" profits through insider trading, it will be possible to compel insiders to disgorge gains made directly to the detriment of market buyers with whom they trade.

As an alternative for specific anti-insider trading provisions might it not be preferable instead to modify and strengthen the disclosure provisions for insiders under the Companies Act along the lines of section 16(a) of the United States Securities Exchange Act 1934, with or without the statutory disgorgement rule provided for in section 16(b)? In my view it would, if we are to have anything at all, for the reasons of simplicity, enforcement, and cost. Ours is only a small securities market in comparison with those in other countries and there is a high degree of institutional involvement as well as considerable public scrutiny of reported share dealings.[111] Compulsory disclosure and the fact that most insiders would not like it to be known that they are taking advantage of inside information may be all that is required to keep the practice under reasonable control.

111. As witness the recent Lion/Androcles affair.

Legislation should clearly not be enacted in the absence of some clear necessity[112] or without far greater investigation than has so far been done of the extent of the problem, its relationship to invididual investor motivation, and the likely effect, both good and bad, which legislation will have. In particular we should consider in some depth the effect of legisation in Australia and the extent to which it has benefitted the market place, business, and investors generally, and we should watch with some considerable interest proposals for further reform which are soon to emerge from the United Kingdom as a follow-up to the aborted bills of 1973 and 1978.

112. On what might constitute necessity see for example R. Baxt "the Rae Report - Quo Vadis" on the situation giving rise to legislation in Australia.

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