Insider Conduct Regulation in New Zealand: Exploring the Enforcement Deficit

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Laws prohibiting insider conduct have now been enacted by most countries with developed or developing securities markets, yet the vigour with which those laws are enforced varies greatly. After experimentation with other models, New Zealand's insider conduct laws have come to closely resemble Australia's, where more than 26 prosecutions have been brought since 2008.[1] *In New Zealand, however, no insider conduct prosecutions have been brought since 2008, and no convictions were secured prior to then. This article examines why New Zealand manifests such a marked enforcement deficit relative to Australia.*

I Introduction

"Insider trading" or "insider dealing" is treated by policymakers in more than 90 countries as a mischief that must be prohibited, with penalties imposed on

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1 Australian Securities and Investments Commission *ASIC enforcement outcomes: July to December 2012* (Report 336, April 2013).

any who engage in it.[2] Broadly, inside information is non-public information which, if it were made public, would affect the price of securities, and using such information in decisions to buy or sell those securities, or disclosing it to third parties, is widely condemned as unfair to non-insiders and injurious to investors and issuers.[3] Insider conduct has been regulated in the United States since 1942[4] and in Canada and France since the 1960s. However, most countries with developed or developing securities markets enacted laws against insider conduct in the 1980s and 1990s.[5] Insider conduct regulation in New Zealand has changed markedly since the late 1980s. Specific statutory insider conduct prohibitions were first enacted in 1988, amended in 2002 and amended again in 2006 (the latter amendments becoming effective in 2008).[6] Since 1988, the rationales underlying prohibition of insider conduct have shifted from fiduciary or similar relationships to an "equal access" rationale. This rationale and the resultant 2008 legislation was transplanted from Australia, where a 1989 report entitled *Fair Shares for All* formed the policy basis for reform in 1991.[7]

For the past 25 years, frequent legal changes and low enforcement levels have reflected a lack of consensus among New Zealand lawmakers, interest groups, enforcement agency leaders, and the public as to whether and why insider conduct should be punished by law. Thus, a regime providing

2 For a comparative table, see Laura Nyantung Beny "The political economy of insider trading laws and enforcement: law vs. politics? International evidence" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar, Cheltenham, 2013) 266 at 287–289.

3 For a recent summary of the arguments against, and for, insider conduct, see Stephen M Bainbridge "An overview of insider trading law and policy: An introduction to the *Research Handbook on Insider Trading*" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar, Cheltenham, 2013) 1 at 19–30.

4 It was not until 1961 that the Securities Exchange Commission asserted that insider conduct on an impersonal stock exchange violated rule 10b-5 (17 CFR § 240), which had been prescribed in 1942 under the authority of § 10(b) of the Securities Exchange Act of 1934 15 USC 78j(b).

5 See table 15.3 in Beny, above n 2, at 287–289.

6 For a comprehensive review of the law on insider conduct before and after the 2006 amendments to the Securities Markets Act 1988, see Shelley Griffiths "The Secondary Market" in John Farrar (ed) *Company and Securities Law in New Zealand* (Thomson Brookers, Wellington, 2008) 1061 at 1083–1111.

7 Standing Committee on Legal and Constitutional Affairs *Fair Shares for All: Insider Trading in Australia* (October 1989). Austin and Ramsay report that "[t]he central recommendation of the Committee was that the 'person connected' criterion should be removed, principally in the interests of simplicity. On this approach, anyone in possession of inside information who knows its significance would be precluded from trading." See RP Austin and IM Ramsay *Ford's Principles of Corporations Law* (14th ed, LexisNexis Butterworths, Chatswood (NSW), 2010) at 563.

exclusively for private enforcement from 1988 to 2002 ended without any damages awards being made. Even after the former Securities Commission gained the power in 2002 to exercise an issuer's right to bring suit, only two actions were initiated. One of these actions (TranzRail) settled; the other (Provenco) was ruled out of time.[8] Since February 2008, an expansive insider conduct regime transplanted from Australia has been in place but no enforcement proceedings have been instituted by the regulator. Has insider conduct simply vanished from New Zealand's financial markets? An absence of insider conduct seems unlikely, so the overall lack of enforcement activity raises a set of questions about past and future insider conduct regulation in New Zealand. These questions are the subject of this article.

Part II of this article provides a historical overview of insider conduct regulation at common law, under the Companies Act 1993, and under the Securities Markets Act 1988 (SMA) in the period between 1988 and 2008. Part III reviews evidence indicating the "private enforcement" approach was fundamentally flawed and limited public enforcement was problematic. For the period from 1988 to 2002, the *Wilson Neill* litigation is emblematic of design flaws and other problems.[9] In particular, the finance scholarship suggests that tightened share trading disclosure obligations did more to deter insider conduct than the insider conduct legislation itself. One common theme since 1988, however, has been an "enforcement deficit" in New Zealand, which exhibits a low rate of prosecution relative to that in Australia.[10] This deficit is relatively easy to explain under the flawed 1988–2008 regime; it is less easy to explain the absence of any prosecutions since 2008 when New Zealand imported from Australia the most expansive insider conduct regime in the world. This difficulty is compounded when one considers

8 *Securities Commission v Midavia Rail Investments BVBA* [2007] 2 NZLR 454 (CA); and "Commission Settles Provenco Insider Trading Case" *The New Zealand Herald* (online ed, Auckland, 3 October 2005).

9 See part III A.

10 New Zealand is not alone in having a weak record of insider trading law enforcement. In the leading study, published in 2002, Bhattacharya and Daouk found that in the 87 countries that then had insider trading laws "[t]he enforcement of these laws, however, has been spotty. We find that there has been a prosecution in only one out of three countries. Developed countries have a better record of prosecution than emerging markets (82 percent of developed countries, and 25 percent of emerging markets have had prosecutions)": Utpal Bhattacharya and Hazem Daouk "The World Price of Insider Trading" (2002) 57 The Journal of Finance 75 at 104. See also Beny, above n 2, at 266–298. On 30 June 2013, the Financial Markets Authority [FMA] advised that in the period 1 July 2012 to 22 April 2013, there were six referrals from the NZX and a member of the public regarding insider conduct. Of these, two were proceeding to an investigation stage; see Financial Markets Authority *Investigations and Enforcement Report 2013* (30 June 2013) at 19.

the recent volume of prosecutions in Australia under the same regime. Part IV examines the apparent lack of a strong constituency in favour of strict enforcement of insider conduct prohibitions, and considers the implications of regime changeability for regulatory efficacy. Part V concludes that, with recent improvements in agency powers, disclosure rules, enforcement policy and agency funding,[11] the missing element continues to be a consensus of purpose that is supportive of insider conduct enforcement.

II Regulatory History: Reform And Amendment

Statutory controls on insider conduct in New Zealand were first enacted in 1988 and significantly amended in 2002, 2006 and 2008. Before 1988, controls on insider conduct were embedded in the common law and company legislation such as the Companies Act 1955. The 1988–2008 insider conduct regime is generally regarded as having failed. Reasons for that failure include: constrained regulatory enforcement powers; insufficient funding of the former Securities Commission; weak disclosure obligations on directors and officers before 2004; and poor regulatory design with over-reliance on private enforcement. Following the failure of the 1988–2008 experiment with private enforcement of insider conduct prohibitions, the post-2008 regime was closely modelled on Australian insider conduct legislation, which gives the regulator wide powers to pursue insider conduct as a civil or criminal matter. Both the Australian and New Zealand regimes are expansive, potentially applying to any person in possession of inside information, but Australia's insider conduct laws are much more aggressively enforced. In New Zealand, however, the majority of pre-2008 regime cases failed or settled. As stated, no prosecutions have been launched under the post-2008 legislation.

A *Insider dealing at common law*

Until 1988, any person incurring loss as a consequence of insider trading by another could seek recourse only at common law or under company legislation. In the leading case of *Coleman v Myers*,[12] the New Zealand Supreme Court (as it then was) and, on appeal, the New Zealand Court of Appeal considered a claim for restitution or damages brought by minority

11 For a recent discussion of reform of the financial markets enforcement regime see Philipp Maume and Gordon Walker "Enforcing Financial Markets Law in New Zealand" [2013] NZ L Rev 263.

12 *Coleman v Myers* [1977] 2 NZLR 225 (SC, CA).

shareholders in a family-owned private company. Two directors of the family company had acquired all of the shares in the company, financing those acquisitions by the subsequent sale of surplus assets owned by the company. Among other causes of action, the minority shareholders claimed they had been induced to sell their shares at an undervalue by certain misrepresentations and non-disclosures on the part of the two directors. The Court of Appeal held the directors owed a fiduciary duty to the company's shareholders, and breached that duty by misleading the minority shareholders and failing to disclose certain material information:[13]

> … in the setting seen here there must be an obligation not to make to shareholders statements on matters material to the proposed dealing which are either deliberately or carelessly misleading. And in my opinion there must at least be an obligation to disclose material matters as to which the director knows or has reason to believe that the shareholder whom he is trying to persuade to sell is or may be inadequately informed.

The Court of Appeal (and Mahon J in the Supreme Court) expressly denied any fiduciary duty being owed by directors to shareholders generally, but were prepared to recognise a fiduciary duty arising in the circumstances of the particular case.[14] Cooke J stated:[15]

> In the particular circumstances of this case it seems to me obvious that each of the respondent directors did owe a fiduciary duty to the individual shareholders. To that extent I fully agree with Mahon J. Broadly, the facts giving rise to the duty are the family character of this company; the positions of father and son in the company and the family; their high degree of inside knowledge; and the way in which they went about the take-over and the persuasion of shareholders.

Since it is clear that in the general run of cases directors' fiduciary duties are owed to the companies they direct and not to shareholders in those companies, plaintiff shareholders seeking compensation at common law for harm occasioned by insider conduct will have to demonstrate that in the particular circumstances they reposed trust and confidence in the directors

13 At 333 per Cooke J.

14 Mahon J considered the decision to the contrary in *Percival v Wright* [1902] 2 Ch 421 (in which Swinfen Eady J had declined to find a fiduciary duty was owed by directors to shareholders with whom they were dealing) to be wrongly decided (at 268–274), while Cooke and Casey JJ in the Court of Appeal considered it not to lay down a general proposition or have relevance in the instant case (at 330 and 371).

15 At 330.

sufficient to give rise to a fiduciary relationship between the parties.[16] It seems that such a relationship will normally arise only in smaller private companies, though exceptionally it might arise in an unlisted public company.[17] In our view, any use of a "fiduciary" rationale to address insider conduct on public securities markets is inappropriate for a number of reasons. First, insiders who trade on public securities markets do not have fiduciary relationships with anonymous buyers. Second, insider conduct is a mischief that demands public enforcement because the commercial vice of insider conduct goes to the integrity of the financial system and public confidence in it. There are hence compelling public policy grounds for state intervention but the nature of a fiduciary relationship does not easily lend itself to public enforcement since — by definition — the fiduciary relationship is private. Finally, as far as non-listed companies are concerned, it is probably the case that s 149 of the Companies Act 1993 (further discussed below) provides a more effective remedy.

B *Insider dealing under the Companies Act 1993*

Historically, company legislation in New Zealand followed United Kingdom models[18] until the Companies Act 1993 was enacted. The 1993 Act was modelled on American and Canadian company law.[19] The current Companies Act 1993 imposes particular restrictions on directors. Relevantly, s 145(1) states that, subject to specified exceptions:

16 Woodhouse J stated at 325 that "while it may not be possible to lay down any general test", relevant factors included a "dependence upon information and advice, the existence of a relationship of confidence, the significance of some particular transaction for the parties and, of course, the extent of any positive action taken by or on behalf of the director or directors to promote it".

17 In *Cottom v GUS Properties Ltd* (1995) 7 NZCLC 260,821 (CA), the Court of Appeal confirmed the applicability of the decision in *Coleman v Myers*, above n 12, and discussed that decision in context of a non-listed company which had 200 shareholders. The Court was prepared to find (at 260,827–260,828, per McKay J) that directors "intending to participate as purchasers in the share exchange, owed a duty to shareholders to ensure they were fully informed of relevant matters known to the directors before making a decision to sell".

18 See Gordon Walker "Reinterpreting New Zealand Securities Regulation" in Gordon Walker, Brent Fisse and Ian Ramsay (eds) *Securities Regulation in Australia and New Zealand* (2nd ed, LBC Information Services, Sydney, 1998) 88.

19 See Gordon Walker and others *Commercial Applications of Company Law in New Zealand* (4th ed, CCH New Zealand Ltd, Auckland, 2012) at 28–30.

> A director of a company who has information in his or her capacity as a director or employee of the company, being information that would not otherwise be available to him or her, must not disclose that information to any person, or make use of or act on the information … .

Section 148 requires a director to disclose to the board his or her dealings in the company's shares. Section 149 goes further and restricts a director who possesses company information by virtue of his or her position as a director "which is information material to an assessment of the value of shares" from acquiring such shares unless the consideration given or received "is not less than the fair value of the shares or securities".[20] In the same circumstances, a director may not dispose of such shares unless the consideration is "not more than the fair value" of those shares or securities. "Fair value" must be determined on the basis of all information known to the director or publicly available at the relevant time.[21] Under s 149(4), the director is liable to the person from whom the shares were purchased or to whom they were sold for the difference between the sale price and the fair value of the relevant shares or securities.[22] Subsection 149(6) states, however, that nothing in s 149 applies in relation to a company to which Part I of the SMA applies. Thus, where the insider conduct regime under Part I of the SMA applies, s 149 of the Companies Act 1993 does not apply. This means that s 149 cannot apply to a "public issuer" as defined in the SMA but can apply to companies that are not publicly listed on a registered exchange in New Zealand.

Some qualifications to the s 149(6) carve-out must be recognised. In May 2011, the former regulator — the Securities Commission — was replaced by the Financial Markets Authority (FMA). The FMA is now empowered by Part 2 of Schedule 1 of the Financial Markets Authority Act 2011 (FMA Act) to enforce the Companies Act 1993 where the latter Act relates or applies to "financial market participants". Under s 4 of the FMA Act, a company that has offered shares to the public (an issuer) is a financial market participant. Accordingly, all breaches of the Companies Act by unlisted issuers and their directors and senior managers fall under

20 Companies Act 1993, s 149(1). Section 149(2) provides that "the fair value of shares or securities is to be determined on the basis of all information known to the director or publicly available at the time". The law on s 149 is discussed in Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (LexisNexis, Wellington, 2011) at 528–530.

21 Companies Act 1993, s 149(2).

22 The leading case is *Thexton v Thexton* [2002] 1 NZLR 780 (CA). In that case, the policy behind s 149 was said to be "abstain or pay fair value", at [19].

the FMA's powers.[23] A further qualification flows from s 13 of the SMA, which prohibits conduct that is misleading or deceptive or likely to mislead or deceive in relation to any dealings in securities. Section 13(2) states that this section applies more broadly than the rest of Part I of the SMA, "and so applies to securities whether listed or non-listed and to all dealings in securities (not only trading)". Accordingly, s 13(2) may be applicable to facts falling within s 149 although s 13(2) does not appear in the Financial Markets Conduct Act 2013.[24]

Insider conduct by directors has probably declined following amendments to the SMA to require directors to disclose their dealings within five days.[25] However, s 149 of the Companies Act continues to have a small but useful role supplementing the SMA in relation to unlisted issuers, who fall *outside* the scope of ss 8C, 8D and 8E of the SMA, because the securities in question are not listed on a registered exchange.

C *The Securities Markets Act 1988*

As of July 2013, New Zealand's securities markets were largely regulated pursuant to the Securities Act 1978 and the Securities Markets Act 1988. Both of these statutes remain in force in 2013 but eventually will be replaced by the Financial Markets Conduct Act 2013 (FMC Act). The FMC Act (an assent copy of which was unavailable at the time of writing) was assented to on 13 September 2013. The Financial Markets Conduct Bill provided for a default commencement date of 1 April 2017 for those parts of the proposed legislation not brought into force before that date. It is expected that some provisons of the FMC Act will come into force in 2014. Under the FMC Act, the FMA remains as the regulator and its enforcement powers will be enhanced.

The Securities Act 1978 introduced New Zealand's first separate securities legislation directed at the primary market. The Securities Act 1978 originally aimed to promote investor protection by a combination of disclosure requirements and private rights of action. The Securities Markets Act 1988 (SMA) was originally enacted as the Securities Amendment Act 1988 but was amended and renamed in 2002. The SMA was the first major attempt to regulate New Zealand's secondary market and brought the first statutory proscription of insider conduct into effect in December 1988. The SMA was motivated in large part by the government's desire to restore

23 See the definition of "financial markets participant" in s 4 of the Financial Markets Authority Act 2011.

24 See part II C.

25 See below n 99, and accompanying text.

investor confidence in New Zealand's capital markets after the 1987 share-market crash.[26] As it transpired, however, New Zealand's securities markets were among the slowest in the world to recover from "Black Monday".[27] Arguably, obstacles to private enforcement of the insider trading prohibition were a factor in the slow post-crash recovery of the markets.

The insider trading prohibitions in Part I of the SMA (as originally enacted) applied to the conduct of "insiders" in relation to the securities of any "public issuer", by parties in possession of "inside information"[28] (these terms being defined in s 2 of the SMA). Four principal prohibitions were set out, each of which was subject to particular exceptions. First, s 7 imposed liability on an "insider" in possession of inside information about a public issuer for buying or selling securities of that public issuer. Secondly, s 9 imposed liability on an insider in possession of inside information about a public issuer for "tipping" any other person. Thirdly, s 11 imposed liability on an insider of one public issuer in possession of inside information about a second public issuer for buying or selling securities of the latter public issuer. Fourthly, s 13 imposed liability on an insider of one public issuer in possession of inside information about a second public issuer for "tipping" any other person regarding the securities of the latter public issuer. For the purposes of ss 9 and 13, "tipping" occurred if the insider advised or encouraged any person to buy or sell, advised or encouraged any person to advise or encourage another to buy or sell, or communicated information to another person knowing or believing that other would either buy or sell or advise or encourage another to buy or sell.[29] In each case, insiders were potentially liable to the person from whom the insider bought the relevant securities or to whom the insider sold the relevant securities, and to the public issuer.[30] The quantum of liability was the loss incurred by the counterparty or, in cases in which the public issuer was the plaintiff, the amount of any gain

26 "Market capitalisation had grown from $17,600m at the end of 1985 to $42,436m at the end of 1986. By 31 December 1987 market capitalisation had actually fallen to $24,200m. The collapse of the share market was followed some 12 months later by the collapse of the commercial property market and the demise of several major financial institutions whose investment and property base had been cut away": Peter McKenzie "Reflections on a Decade with the Securities Commission 1985–1995" (1996) 6 Canta LR 215 at 215.

27 Brian Gaynor "Securities Regulation in New Zealand: Crisis and Reform" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) 10 at 11.

28 Interpretive issues in the meaning of "inside information" under the SMA are explored in Keith Kendall and Gordon Walker "Insider trading in Australia and New Zealand: Information that is 'generally available'" (2006) 24 C&SLJ 343.

29 Securities Markets Act 1988, ss 9(1) and 13(1).

30 Sections 7(2), 9(2), 11(2) and 13(2).

made or loss avoided as a result of the trading plus any amount considered by the Court to be an appropriate pecuniary penalty. Pecuniary penalties were capped at the greater of the total consideration paid or received, or three times the gain made or loss avoided.[31] Amounts recovered by public issuers were to be held on trust for distribution in accordance with the Court's directions — for example, to present or past members of the issuer.[32] No criminal sanctions attached to insider conduct at this time.

Originally, the Securities Commission had no power to pursue an insider conduct prosecution. It was up to the aggrieved shareholder to pursue private enforcement. This policy was unrealistic but reflected the non-interventionist stance of the government. Consider, for example, a typical individual investor trading on the NZSE (as it then was) who has sustained a modest loss in consequence of insider conduct and who is in the unlikely position of having clear evidence of insider conduct by the counterparty. Civil legal aid would be unavailable to such an investor. His or her decision to litigate would turn on weighing the quantum of loss and the costs of litigation. Unless the loss was substantial, the investor would have no incentive to litigate, as litigation costs would exceed damages, even if costs were awarded. Litigation might become rational if a class action were possible, but legislation to support class actions has not yet been introduced to Parliament. Consider, next, a high-net-worth individual investor or investment company with a suspicion of insider conduct by the counterparty and substantial losses but (quite plausibly) no clear evidence of breach. Again, the decision to litigate would turn on a weighing of litigation costs and likely damages. Assuming the affected trader was in the business of trading shares, the rational decision might be to utilise the tax loss rather than litigate. It is apparent that the quantum of loss, costs of litigating and availability of evidence will seldom coincide to make private enforcement economically rational for the plaintiff investor.

The first solution to address this problem was ineffective. To assist potential plaintiffs, former s 17 of the SMA allowed present or past members of a public issuer to seek the Securities Commission's approval for the issuer to obtain, at the issuer's expense, a barrister's or solicitor's opinion on whether or not the issuer had a cause of action against the insider. Former s 18 provided that a public issuer's right of action against an insider might be exercised by a member of the issuer, with the Court's leave. This innovation suffered from practical design flaws (such as the question of initial costs) and introduced the possibility of a "free rider" problem, whereby the well-resourced shareholder might seek to shift litigation costs to the company, at the expense of all shareholders.

31 Sections 7(3), 9(3), 11(3) and 13(3).

32 Section 19.

D *The Securities Markets Amendment Act 2002*

Following approximately 14 years of weak enforcement, the SMA was amended in 2002 with the objective of enhancing enforcement. The Russell Committee[33] and Roche Committee[34] had each reported on proposals for regulatory reform. The prevailing view was that removing obstacles to private enforcement was the optimal solution.

The Securities Markets Amendment Act 2002 took effect in December 2002,[35] amending the Securities Markets Act 1988 by adding new ss 18A–18E, which continued in force until the Securities Markets Amendment Act 2006 commenced in February 2008. Under s 18A, the former Securities Commission gained the power to exercise a public issuer's right of action against an insider if the Commission considered it in the public interest to do so. The Commission could commence proceedings without the leave of the Court, if the public issuer did not object, or with the Court's leave if the public issuer objected.[36] The Commission could, with the Court's leave, also take over proceedings commenced by the public issuer or another person.[37] The Court was required to grant leave if satisfied that it was in the public interest for the proceedings to be brought or continued by the Commission.[38]

The Commission used its new powers in two instances. First, it commenced action in 2004 in relation to the alleged selling of TranzRail shares by individuals in possession of inside information. The sales had occurred in 2002, some two and a half years before proceedings were commenced. However, the Limitation Act 1950 provided that, where a penalty is in issue, proceedings must be commenced within two years of the date the cause of action arose. This proved fatal to the Commission's claim for pecuniary penalties (though its case for compensation remained on foot and was subsequently settled with a total of $27.5 million being paid by six defendants).[39] The second case concerned an allegation of insider conduct in relation to Provenco shares in 2003. This claim was settled in 2005.[40]

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33 Andrew Simpson "The First and Second Spenser Russell Reports on Securities Law Reform in New Zealand*"* (1993) 11 C&SLJ 188.

34 Andrew Simpson "The Roche Report on Securities Law Reform in New Zealand" (1993) 11 C&SLJ 331.

35 Provisions in the same amending Act to enhance insider disclosure obligations commenced on a later date: Securities Markets Amendment Act 2002, s 2(2).

36 Securities Markets Act 1988, s 18B(1) and (2)(a).

37 Section 18B(2)(b).

38 Section 18B(3).

39 *Midavia Rail Investments BVBA*, above n 8; and Securities Commission "Midavia, Richwhite insider trading case settled" (press release, 19 June 2007).

40 "Commission Settles Provenco Insider Trading Case", above n 8.

E *The Securities Markets Amendment Act 2006*

A major overhaul of insider conduct regulation under the SMA came into force in February 2008 with the commencement of the Securities Markets Amendment Act 2006.[41] These reforms were based on the Australian model of insider conduct controls,[42] largely following Part 7.10 of Division 3 of the Corporations Act 2001 (Cth). The Australian regime is the most expansive in the world, being directed at "a person" who "possesses inside information",[43] although the wide ambit of the Australian provisions is qualified by a set of statutory carve-outs. The cognate New Zealand statutory prohibition remains largely unaffected by the Financial Markets Conduct Act 2013.[44] Overall, the FMC Act moves the New Zealand law even closer toward the Australian model.

Part 1 of the SMA creates three criminal offences in relation to insider conduct concerning securities: the trading offence; the disclosing offence ("tipping"); and the advising or encouraging offence.[45] The same three offences apply to insider conduct in relation to futures contracts.[46] The trading offence is committed where an information insider of a public issuer trades in securities of the public issuer.[47] Secondly, the disclosing offence is committed where an information insider (A) of a public issuer directly or indirectly discloses inside information to another person (B), provided A knows or ought reasonably to know or believe that B will trade or is likely to trade securities of the public issuer or, if B is already a holder of those

41 Securities Commission *New Securities Law for Investment Advisers and Market Participants 2008: A guide to new requirements under the Securities Markets Act 1988* (December 2007).

42 Kendall and Walker, above n 28. For an overview of the Australian law on insider trading, see Austin and Ramsay, above n 7, at 9.600 et seq. See also Ashley Black "Insider trading and market misconduct" (2011) 29 C&SLJ 313. A key implication is that one must largely look to the Australian case law for guidance on judicial consideration of the cognate sections. So, for example, in *Mansfield v R* [2012] HCA 49, (2012) 293 ALR 1 the High Court of Australia held that the term "information" can include false information. For commentary see Juliette Overland "What is 'inside information'? Clarifying the ambit of insider trading laws" (2013) 31 C&SLJ 189. There has been no judicial consideration of the post-2008 regime by the New Zealand courts.

43 Corporations Act 2001 (Cth), s 1043A(1)(a). As to the meaning of the term "possession", see *R v Hannes* [2000] NSWCCA 503, (2000) 158 FLR 359 (possession connotes an element of awareness of the relevant information).

44 See Financial Markets Conduct Bill 2011 (342-2) cls 234–255. At the time of writing, the assent copy of the FMC Act was unavailable.

45 Securities Markets Act 1988, ss 8C, 8D and 8E.

46 Section 11E.

47 Section 8C.

securities, continue to hold them or advise or encourage another person (C) to trade or hold them.[48] Thirdly, the advising or encouraging offence is committed where an information insider (A) of a public issuer either: (i) advises or encourages another person (B) to trade or hold securities of the public issuer; or (ii) advises or encourages (B) to advise or encourage another person (C) to trade or hold those securities.[49]

While the SMA is silent as to its territorial scope, it seems clear that the insider conduct regime is confined to conduct relating to trading or holding (or advising or encouraging another to trade or hold) securities of a public issuer which are listed on a registered exchange's securities market in New Zealand.[50] The relevant insider conduct must involve trading in securities, continuing to hold securities, or advising or encouraging another to trade or hold securities.[51] The insider conduct provisions apply to any person who is "an information insider of a public issuer",[52] where a "public issuer" is a person who is or was a party to a listing agreement with a registered exchange.[53] The NZX is a "registered exchange" for the purposes of the SMA and the three markets operated by the NZX are accordingly registered securities markets operated by a registered exchange (the NZX). Together, these provisions mean that the insider conduct regime is confined to conduct relating to trading or holding (or advising or encouraging another to trade or hold) securities of a public issuer which are listed on a registered exchange's securities markets in New Zealand.[54]

An "information insider" must have material information relating to the public issuer that is not generally available to the market, and know (or ought reasonably to know) both that the information is material information and that it is not generally available to the market.[55] A public issuer may be an information insider of itself.[56]

48 Section 8D.

49 Section 8E.

50 *Securities Commission v Midavia Rail Investments BVBA* [2006] 2 NZLR 207 (HC). In a similar fashion, the powers of the FMA insofar as they relate to "financial markets" apply to financial markets in New Zealand: Financial Markets Authority Act 2011, s 4.

51 Securities Markets Act 1988, ss 8C, 8D and 8E.

52 Sections 8, 8C, 8D and 8E.

53 A "registered exchange" is a person who holds a market registration under s 36F of the SMA: Securities Markets Act 1988, s 2.

54 In a similar fashion, the powers of the FMA insofar as they relate to "financial markets" apply to financial markets in New Zealand: Financial Markets Authority Act 2011, s 4.

55 Securities Markets Act 1988, s 8A.

56 Section 8A(2).

Contravention of ss 8C to 8E is a criminal offence.[57] Civil liability also attaches such that an "aggrieved person" may seek to recover compensation for loss or damage. Civil remedies are available for breach of the insider conduct prohibition.[58] First, the FMA may seek a pecuniary penalty and declaration of contravention.[59] Secondly, an "aggrieved person" who has suffered loss or who is likely to suffer loss may apply for a compensatory order.[60] There are eight exceptions or "safe harbours" to the prohibitions on insider conduct[61] and five affirmative defences.[62] The accused party bears the onus of proving each of the statutory affirmative defences but only to the civil standard of the "balance of probabilities". Consequently, along with Australia, the FMA possesses a formidable regulatory armoury to pursue insider conduct.

F *New financial markets laws*

Recent financial market reforms in New Zealand have been impelled by three key drivers: globalisation, the regional free trade agreement with Australia, and domestic politics. Globalisation of securities markets entails that New Zealand's markets are profoundly affected by international conditions and events.[63] Just as the worldwide stock market crash of 1987 provided the

57 Section 8F. For an individual, the maximum penalty is imprisonment for a term not exceeding five years or a fine not exceeding $300,000 or both; for a company, the maximum penalty is a fine not exceeding $1,000,000: s 43.

58 Section 42R.

59 Sections 42T–42Z. The maximum amount of a pecuniary penalty for a contravention of an insider conduct prohibition is the greater of: (a) the consideration for the transaction that constituted the contravention (if any); or (b) three times the amount of the gain made, or the loss avoided, by the person in carrying out the conduct; or (c) $1,000,000: s 42W.

60 Sections 42ZA and 42ZB.

61 The insider conduct prohibitions do not apply to excepted forms of conduct: trading activity and disclosures that are required by an enactment; acquisitions, disclosures and advice or encouragement that occur under an underwriting or sub-underwriting agreement or for the purpose of negotiating such; trading as an agent who acts on specific instructions to trade securities, without having received inside information, advice or encouragement; specified trading, disclosing and advising in connection with a takeover offer under the Takeovers Code; redemption of units in a unit trust at a price based on the underlying value of the assets; and trading by the Reserve Bank of New Zealand in securities issued by itself or by the Crown: ss 9–9G.

62 Sections 10–10D.

63 See Gordon Walker and Mark Fox "Globalization: An Analytical Framework" (1996) 3 Indiana Journal of Global Legal Studies 375; and Franklin Gevurtz "The Globalisation of Insider Trading Prohibitions" (2002) 15 Transnat'l Law 63.

impetus for the first statutory regime directed at insider conduct under the SMA, the global financial crisis of 2008 also prompted major reform.[64] This included the establishment of the FMA as the new market regulator pursuant to the Financial Markets Authority Act 2011,[65] and the introduction to Parliament of the Financial Markets Conduct Bill 2011. Domestic political imperatives have also been influential. The Financial Markets Conduct Bill 2011 is driven in large part by the political objectives of the centre-right coalition led by the National Party. One objective is to partially remedy the damage caused by the collapse of finance companies in the wake of the global financial crisis.[66] The government's desire to strengthen domestic investor confidence in the regulatory regime prior to privatising certain state-owned enterprises is another objective.[67]

As stated, the Financial Markets Conduct Act 2013 will repeal the Securities Act 1978 and the SMA, and replace both statutes with one omnibus Act covering the primary and secondary markets.[68] As of August 2013, an assent copy of the FMC Act was unavailable, but the relevant clauses of the Bill did not change the current insider conduct regime in any substantial manner.

One consequence of the legislation establishing the FMA is that "securities regulation" is no longer a distinct body of law in New Zealand: it is now subsumed under the rubric of financial markets law.[69] The FMA's enhanced powers to monitor compliance and investigate conduct apply fully to the Securities Act 1978 and SMA, including the insider conduct

64 See Philipp Maume and Gordon Walker "Capital Markets Matter: A New Era in New Zealand Securities Regulation" (2011) 29 C&SLJ 184.

65 See Philipp Maume and Gordon Walker "Goodbye to all that: A New Financial Markets Authority for New Zealand" (2011) 29 C&SLJ 239; and Philipp Maume "The Financial Markets Authority: A Model Example for Regulatory Consolidation?" (2013) 25 NZULR 616.

66 See Mark A Fox, Gordon R Walker and Alma Pekmezovic "Corporate Governance Research on New Zealand Listed Companies" (2012) 29 Arizona Journal of International & Comparative Law 1.

67 See Public Finance (Mixed Ownership Model) Amendment Act 2012.

68 "The initial issuance and sale of securities by a startup company represents the first stage in creating a market for a company's securities. Once the shares or other securities are in the hands of those initial purchasers, they can be resold to other investors, thus providing liquidity for the original purchaser. In this secondary 'resale' market, of course, no cash is generated for the issuer, only for the seller." Stephen F Diamond "The Facebook effect: secondary markets and insider trading in today's startup environment" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar, Cheltenham, 2013) 99 at 103.

69 See Philipp Maume and Gordon Walker "A New Financial Markets Law for New Zealand" (2011) 29 C&SLJ 455.

provisions.[70] As stated, the FMA's powers in relation to the Companies Act 1993 apply only to the extent that the Companies Act applies or relates to "financial markets participants",[71] and hence a director or senior manager of an unlisted issuer may be subject to the FMA's powers.[72] In addition, the FMA has the power (subject to considerations such as the public interest) to exercise a person's right of action in respect of insider conduct under s 34 and subsequent sections of the FMA Act.

As a result, the FMA has ample powers to pursue insider conduct. The FMA's information-gathering and enforcement powers under Part 3 of the FMA Act are considerably improved relative to those of the former Securities Commission, though it should be noted that the FMA is unable to obtain warrants to use interception devices in investigations (unlike securities regulators in Australia and the United States).[73] In striking contrast to Australia, however, no prosecutions for insider conduct have been initiated under the 2008 regime in New Zealand.

III Regime Performance: The Enforcement Deficit

Even a brief review of the outcomes achieved in insider trading proceedings in New Zealand reveals quite starkly the lack of successful enforcement action against insider conduct. The very few cases that have been decided strongly suggest weaknesses in the insider conduct regimes hitherto applied. Some additional light is cast on the performance of insider conduct regulation in New Zealand by quantitative studies published by finance scholars. While this literature is not comprehensive, it nevertheless offers important clues to the role of insider conduct regulation in New Zealand's securities markets.

70 Financial Markets Authority Act 2011, pt 1 of sch 1.

71 Section 4 and pt 2 of sch 1.

72 See Walker and others, above n 19, at 320.

73 The Search and Surveillance Act 2012, s 45 does not authorise use of an interception device to investigate an offence punishable by less than seven years' imprisonment. Compare the Telecommunications (Interception and Access) Act 1979 (Cth) and the Omnibus Crime Control and Safe Streets Act of 1968 18 USCA §§ 2510–2522. For a discussion of telecommunications interception warrants in Australia see Tom Middleton "ASIC's regulatory powers — interception and search warrants, credit and financial services licences and banning orders, financial advisers and superannuation — Problems and suggested reforms" (2013) 31 C&SLJ 208 at 211–215.

A *The failure of private enforcement*

Private enforcement of the insider trading prohibitions was first tested in New Zealand in the *Wilson Neill* litigation,[74] which served to highlight fundamental design weaknesses in the 1988 legislation. In July 1991, Wilson Neill Ltd (WNL) had placed 13 million shares with various institutional investors at $0.40 per share, after Magnum, another WNL investor, had decided not to acquire those shares pursuant to an option. By the end of 1991, the shares were worth only $0.10 each. The complaining shareholders (institutional investors and one private investor) alleged that WNL had a right of action against Magnum, WNL's then Chief Executive, and certain other executives and associated companies, on the basis that those insiders had allegedly sold WNL shares while in possession of material non-public information concerning the company's unfavourable prospects. With the Securities Commission's approval, the complaining shareholders required WNL to obtain an opinion from a leading Queen's Counsel, who considered that WNL had a reasonably good cause of action against two of the alleged insiders, but that the position in respect of Magnum and two other alleged insiders was much more equivocal. The complaining shareholders sought to rely on s 18 of the SMA to require WNL to exercise the alleged right of action. Although the complaining shareholders were at liberty to sue in respect of their own cause of action for losses they sustained, requiring the issuer to bring suit would have two advantages for them: first, it was only in relation to the issuer's cause of action that the Court was entitled to award a pecuniary penalty; and secondly, the issuer would be liable to pay the shareholders' costs in taking the issuer's case.[75]

In the High Court, Heron J was satisfied that "good reason for not bringing the action" had been shown,[76] and refused to grant leave under s 18 of the SMA to the complaining shareholders. Heron J's decision was upheld in the Court of Appeal, which took a broad view of the "good reason" ground for denying leave:[77]

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74 *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1993] 2 NZLR 617 (HC) [*Wilson Neill (No 1)*]; *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd (No 2)* [1993] 2 NZLR 657 (HC) [*Wilson Neill (No 2)*]; *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 (CA) [*Wilson Neill (CA)*]. For a full discussion see Craig Mulholland "Insider Trading in New Zealand: Aspects of the *Wilson Neill Case*" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (Oxford University Press, Auckland, 1994) 641.

75 *Wilson Neill (No 2)*, above n 74, at 664.

76 At 681.

77 *Wilson Neill (CA)*, above n 74, at 160.

> What may constitute good reason, however, is not restricted. Considerations including the strength or weakness of the case, the financial position of the public issuer on which the costs of an action will fall (subject only to any order ultimately made against a defendant) and the interests of other shareholders must be among the total circumstances of the case open to be taken into account.

Both courts evidently entertained concerns regarding the effect that granting leave would have on WNL as a whole and on its shareholders generally.[78] Both courts observed that the complaining shareholders were in a position to litigate their claims in their own names and at their own expense.[79] Quite possibly Parliament had in mind shareholders of smaller resources when it enacted ss 17–19 of the SMA. The *Wilson Neill* decisions, however, signalled to prospective litigants that the courts would not lightly "allow a free hand to a third party to undertake complex litigation at the expense of a public company containing many shareholders".[80]

The approach the New Zealand courts adopted toward proceedings under s 18 of the SMA significantly diminished the utility to complainant shareholders of the procedure for issuer funding of actions against alleged insiders. Several different problems contributed to the inutility of s 18. First, the legislation itself was silent on important questions of procedure. While a number of these questions were resolved in the course of the various *Wilson Neill* hearings, those hearings may well have deterred potential applicants from availing themselves of what was probably perceived as an uncertain and costly avenue of redress. Secondly, the procedure *Wilson Neill* demanded under s 18 involved "three different trials at three different levels of proof",[81] along with the concomitant expense. Thirdly, directors of the issuer who were innocent of wrongdoing could be expected to oppose the

78 *Wilson Neill (No 2)*, above n 74, at 682; and *Wilson Neill (CA)*, above n 74, at 161.

79 "[T]he availability of proceedings to the complaining shareholders in their own right is critical. They are substantial investors in the marketplace and can foot it with the others": *Wilson Neill (No 2)*, above n 74, at 679 per Heron J. "If the institutional appellants wish to litigate their claims against Magnum they remain free to do so in their own names in exercise of their own alleged causes of action. The litigation should not be pursued at the cost of the other shareholders in Wilson Neill": *Wilson Neill (CA)*, above n 74, at 162 per Cooke P.

80 *Wilson Neill (No 2)*, above n 74, at 682 per Heron J.

81 Mulholland, above n 74, at 655: "First, there is the [shareholders'] request to the NZSC that a barrister be appointed at the company's expense to investigate. The barrister then has to report as to whether or not there are grounds for mounting an insider-trading case (trial one). Second, application has to be made to a judge to obtain leave to issue proceedings (trial two). Third, if shareholders want to bring action in the name of the public issuer, then leave of the court is also required (trial three)."

proceedings: they might sympathise with the accused insiders if they were also directors ("boardroom bias"), or simply be resistant to the company suffering the expense and adverse publicity that proceedings would entail. Fourthly, the courts' concern to avoid burdening shareholders with the expense of litigation that is potentially beneficial only to a small sub-set of shareholders reveals a fundamental flaw in the regime: the benefits are concentrated while the costs are diffuse. The risk of plaintiff "free-riding" therefore arises. The costs of any issuer-funded insider conduct litigation under s 18 were borne, ultimately, by all of the members, most of whom would be likely to have suffered little or no loss as a result of the impugned conduct. The shareholders who were motivated to use the s 18 procedure were likely to be relatively well-resourced investors who had a relatively large stake in the issuer, and who had suffered a sufficiently large loss to make the application worthwhile. If the courts are sceptical of the desirability of issuers funding litigation to the benefit of well-resourced applicants, and are careful to prevent litigation costs being transferred to investors unaffected by insider conduct, then such a procedure could have only a very limited scope of application in practice.

B *The absence of public enforcement*

The former Securities Commission did not in general achieve a strong track record on enforcement.[82] Although fundamental reforms aligned New Zealand's insider conduct law with Australia's from February 2008, there has been no enforcement activity in New Zealand under the new regime. In New Zealand, all of the insider conduct cases reported since 2008 were commenced under the pre-2008 insider conduct regime.[83] No mention of any insider conduct prohibitions is made in any of the Annual Reports of the Securities Commission for the years 2008–2011; the 2008/09 financial review of the Securities Commission by Parliament's Commerce

82 The enforcement of New Zealand securities regulation has been problematic from the outset. For representative criticism across the years see JH Farrar "The Securities Act 1978" (1979) 8 NZULR 301; Gaynor, above n 27; Peter Fitzsimons "Controlling Insider Dealing — The 'Civil' Approach in New Zealand" (1997) 4 Journal of Financial Crime 309; Marina Nehme "Birth of a New Securities Law Regulator: The Financial Markets Authority and the Powers at its Disposal" [2011] NZ L Rev 475; and P Maume *The New Zealand Financial Markets Authority* (SJD thesis, La Trobe University, 2012).

83 See, for example, *Haylock v Patek* [2011] NZCA 679, [2012] 1 NZLR 665.

Committee;[84] the 2009 Prada Report[85] or otherwise on the FMA website. The FMA has not launched any prosecutions for insider conduct following its establishment in May 2011. By contrast, the Australian Investments and Securities Commission (ASIC) recorded a total of 33 referrals of insider conduct matters to the Deterrence Section within ASIC in the period 1 August 2010 to 31 December 2011.[86]

It seems unlikely that insider conduct has disappeared entirely from New Zealand's securities markets, however. The Special Division report in the Annual Reports of the New Zealand Markets Disciplinary Tribunal discloses the Division received a total of 39 SMARTS alerts in the period from January 2009 to December 2011.[87] If SMARTS alerts indicate prima facie, at least, that insider conduct may be occurring, the question arises as to why no insider conduct enforcement actions have been commenced since 2008. Possible reasons for New Zealand's apparent insider conduct enforcement deficit include the former Securities Commission's lack of adequate funding, unsupportive community expectations and competing enforcement priorities.

The FMA has announced its enforcement policy,[88] which will be critical to its success or failure. The policy states, inter alia, that the FMA "targets conduct that harms or presents the greatest likelihood of harm to the function of open, transparent, efficient capital markets".[89] The FMA also will actively enforce compliance with the new licensing regime for trustees and statutory supervisors from October 2011.[90] The FMA's prosecution of the finance company cases arising before the new regime came into effect in October 2011 provides some grounds for confidence in the FMA's willingness to take action in this category of cases. By August 2012, the FMA reported that 65 finance companies had failed, resulting in the loss of an estimated $3.1

84 Commerce Committee *2008–09 financial review of the Securities Commission* (20 November 2009).

85 Michel Prada and Neil Walter *Report on the Effectiveness of New Zealand's Securities Commission* (Securities Commission, September 2009).

86 Australian Securities and Investments Commission *ASIC supervision of markets and participants: July to December 2011* (Report 277, February 2012). See also Keith Kendall and Gordon Walker "Insider trading in Australia" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Edward Elgar, Cheltenham, 2013) 365.

87 The SMARTS system provides electronic surveillance of market activity and generates alerts in relation to suspicious activity which may warrant further investigation.

88 See Financial Markets Authority "FMA Enforcement Policy" <www.fma.govt.nz>.

89 Financial Markets Authority, above n 88. The FMA's Enforcement Policy also announces that "FMA will work closely with NZX, and actively monitor conduct in traded markets with a view to taking early action should the need arise".

90 Financial Markets Authority, above n 88.

billion, with another $8.6 billion at risk.[91] The FMA has so far completed investigations into 26 failed finance companies, including 11 cases that are currently before the courts or have been concluded.[92] The FMA is investigating a further 25 cases with a view to ascertaining which of these might be prosecuted.[93] We now turn to explore possible reasons for the apparent low priority given to prosecutions for insider conduct.

IV Regime Legitimacy: The Lack of a Policy Consensus

The absence of insider conduct enforcement in New Zealand since 2008, and resulting enforcement deficit relative to Australia, suggests either of three broad possibilities: first, either insider conduct is not occurring in New Zealand and enforcement action is therefore unneeded; or, second, some level of insider conduct is occurring but the enforcement agency has not been in a position to prosecute; or, third, the enforcement agency has been aware of possible breaches and able to prosecute but has elected not to do so. We think that insider conduct may have diminished following enactment of more rigorous insider disclosure requirements but has probably not been eradicated. We also think, however, that the former Securities Commission and the present FMA have elected not to pursue cases of suspected insider conduct because the finance company collapses presently have a higher enforcement priority. Given the large sums of money that retail investors have lost, the large number of investors affected and the finite budget of the FMA, the prioritisation of finance company collapses is readily understandable. On the other hand, if insider conduct does not have a high enforcement priority, then perhaps this tells us something about how the offence is perceived in this jurisdiction.

A *Does insider conduct persist in New Zealand?*

It seems unlikely the successive prohibitions of insider conduct have completely deterred insider conduct in New Zealand. The recent lack of insider conduct prosecutions might be explained in part, however, by contemporaneous changes in associated regulation. It may be that the insider

91 Financial Markets Authority *Inquiries, Investigations and Enforcement Report* (August 2012) at 6.

92 Financial Markets Authority "Questions and Answers About our Finance Company Investigations" <www.fma.govt.nz>.

93 Financial Markets Authority "Finance Company cases before the Court" <www.fma.govt.nz>.

conduct regime overall is working quite well, by reason of the continuous disclosure obligations[94] rather than the conduct prohibitions. Research by finance scholars supports this hypothesis.

In a paper published in 2004, Etebari and others examine transactions disclosed by corporate insiders for a sample of 93 listed companies on the NZSE from 1995 to 2001, during which period disclosure obligations were "two-tiered".[95] The authors draw attention to the differential between the "immediate disclosure" obligations of substantial shareholders and the "delayed disclosure" required of directors and executives.[96] A key finding of the study is that large abnormal gains to insiders came "largely from transactions involving delayed disclosure" whereas "transactions involving immediate disclosure earn insignificant returns".[97] One implication of this study is that well-crafted disclosure rules have a significant impact on the incidence of insider conduct.

A 2007 paper by Gilbert and others examined the effect on the market of SMA amendments which required all corporate insiders to disclose details of their trading within five trading days and increased the enforcement powers of the Securities Commission.[98] Their results "provided strong evidence that the regulatory changes have resulted in a significant reduction of the microstructure effects of insider trading".[99] The authors conclude that "the change in regulations has had a positive impact on the market".[100]

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94 An effective continuous disclosure regime reduces the incidence of insider conduct by narrowing the information asymmetry between insiders and the market generally.

95 Ahmad Etebari, Alireza Tourani-Rad and Aaron Gilbert "Disclosure regulation and the profitability of insider trading: Evidence from New Zealand" (2004) 12 Pacific-Basin Finance Journal 479.

96 At 481: "Until recently, disclosure laws in New Zealand regarding insider trading were vastly different from those of other developed markets. Under the [SMA] only substantial shareholders (SSH), those shareholders with over 5 per cent of the company's shares, were required to disclose their trading in a timely fashion and even then only when their holding changed by a cumulative 1 per cent since the previous disclosure. As for directors and executives, only company directors were required to disclose their trading in their annual report, while executives who were non-board members were not required to disclose their trading at all. This meant that only large shareholders disclosed trading in a timely fashion, within five days of the trade, while ordinary directors disclosed, on average, 9–10 months after the transaction."

97 At 479.

98 A new Part 2 was inserted in the SMA by s 16 of the Securities Markets Amendment Act 2002, providing for: continuous disclosure by public issuers; disclosure by directors and officers; and disclosure of interests of substantial security holders in public issuers.

99 Aaron Gilbert, Alireza Tourani-Rad and Tomasz Wisniewski "Insiders and the Law: The Impact of Regulatory Change on Insider Trading" (2007) 47 MIR 745 at 763.

100 At 763.

Because the Securities Commission's enforcement powers were increased around the same time that disclosure requirements were tightened,[101] it is difficult to be certain as to which of those changes caused the effects observed by Gilbert and others. In the absence, however, of any high-profile prosecutions, it seems unlikely that the changes to enforcement powers have substantially deterred insider conduct.[102] If Etebari and others are correct that rules requiring prompt disclosure by insiders are associated with much lower returns on insider transactions, then stricter disclosure requirements may have resulted in less insider conduct occurring by diminishing the incentives to engage in it. It is possible, therefore, that the imposition of enhanced disclosure obligations on insiders is the key factor in the low incidence of insider conduct prosecutions in New Zealand in recent years.

Unfortunately, we cannot say that insider trading does not occur in New Zealand. As Gevurtz points out, "[u]nfortunately, unlike homicides, robberies, and other commonly reported crimes, there are no regularly reported statistics on illegal insider trading".[103] While prosecutions for insider conduct are reported when they occur, the offending conduct is very much less apparent to its victims than is most other criminal conduct. Intuitively, it seems very unlikely that disclosure requirements and insider conduct prohibitions are one hundred per cent effective in deterring insiders from trading or tipping, or that corporate insiders in New Zealand have become more virtuous or restrained than their counterparts in other jurisdictions. If we assume that some level of insider conduct contrary to the law persists in New Zealand's securities markets, as in the securities markets of other developed countries, then it becomes necessary to consider why the level of enforcement activity in New Zealand has been so low.

B *Resource constraints*

Perhaps the most obvious reason for New Zealand's lack of insider conduct enforcement is the limited resourcing hitherto granted to the responsible agency. The report by Prada and Walter found that "[i]t is clear from the

101 The Securities Markets Amendment Act 2002 commenced on 1 December 2002, except for the disclosure amendments, which commenced on 3 May 2004.

102 Bhattacharya and Daouk, above n 10, at 104 find that "the establishment of insider trading laws … is not associated with a reduction in the cost of equity. It is the difficult part — the enforcement of insider trading laws — that is associated with a reduction in the cost of equity in a country."

103 Gevurtz, above n 63, at 90.

review team's surveys and research that under-resourcing is at the heart of many of the Commission's current problems".[104]

Another explanation looks to the political culture: public expectations inevitably influence an enforcement agency's priorities, and hence its activities, though arguably they ought not to be determinative of them. It is striking that the former Securities Commission did not originally have an enforcement function at all. A former Chairman of the Securities Commission, Peter McKenzie, observed:[105]

> The enforcement of the Securities Act and the Companies Act remained with the Registrar of Companies and the Corporate Fraud Squad of the Police, and when it was later established, the Serious Fraud Office. The Commission's statute did not make it a corporate policeman. *Both the government and the business community wished to establish a much less interventionist body* than the SEC in the United States or the ASC in Australia. The Commission was to be a corporate watchdog with power to bark, but the biting was to be left to others.

McKenzie's reference to the wishes of the government and the business community is significant. The former Securities Commission gained the power in 2002 to exercise an issuer's right to claim compensation from an insider. This suggests that by 2002 the Government wished the Commission to become a more interventionist body. As we have seen, however, even after it gained the power to intervene, the Securities Commission seldom did so.

A form of industry levy will be one primary means of funding the new body along with governmental subvention.[106] The new FMA has been granted a more generous budget allocation than its predecessor, but has been confronted with the significant challenge of urgent demands to investigate and (in appropriate cases) take action against those involved in the large number of finance company collapses since 2006. Thus, a third factor apparently contributing to the lack of insider conduct enforcement action is a "crowding out" of such enforcement by prosecutions relating to finance companies.

The FMA (and the former Securities Commission) cannot be expected to prosecute every breach that comes to its attention, since it must make efficient and effective use of the finite resources available to it whether from public funds or industry levies. Accordingly, even well-founded suspicions of insider conduct might not be investigated or prosecuted, if

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104 Michel Prada and Neil Walter *Report on the Effectiveness of New Zealand's Securities Commission* (Securities Commission, September 2009) at 29.

105 McKenzie, above n 26, at 217 (emphasis added).

106 See Philipp Maume "A levy for New Zealand's financial markets" (2013) 31 C&SLJ 56.

other enforcement matters are considered as taking priority. As stated, it seems reasonable to suppose that the finance company collapses which have direly affected the savings of about 205,000 New Zealanders have commanded a higher enforcement priority than suspected occurrences of insider conduct (assuming any such were detected).

A fourth explanation connected with the aforementioned reform of insider disclosure requirements also appears relevant in connection with enforcement priorities. More onerous disclosure obligations may have caused insider conduct in New Zealand to diminish in both frequency and economic impact. If so, this would appear likely to have had the effect of making insider conduct prosecutions a less urgent priority, relative to other forms of conduct perceived as more prevalent and more damaging. This is not to say that continuous disclosure rules supplant either conduct rules or their enforcement. The opportunity for insider conduct is diminished if disclosure rules are adequate and properly enforced. In relation, however, to any insiders who disregard the disclosure rules and contemplate exploiting the opportunity to profit from their undisclosed inside information, the necessity remains for negative sanctions to deter that conduct.

It remains to consider the reasons for the absence of significant public demand for, or political expectation of, enforcement action against insider conduct in New Zealand.

V Conclusion

We think the absence of enforcement action against insider conduct in New Zealand is consistent with insider conduct having a lower enforcement priority relative to other forms of misconduct in the securities markets, as the foregoing section explained. This apparent lower prioritisation of insider conduct enforcement manifests in a context of finite agency resources and prolific finance company failures. It also appears that public concern regarding insider conduct is relatively weak.[107] After 2004, the level of press reporting on insider trading in New Zealand dropped off markedly. By contrast, the level of press reporting in Australia increased consistent with the transfer of "front line" responsibility for market participant oversight and

107 Gevurtz, above n 63, at 64 laments that "[u]nlike the situation with murder, robbery or bribery, there has been no longstanding or universal condemnation among human civilizations of transacting business based upon inside information" (footnotes omitted). See also Joel Seligman "The Reformulation of Federal Securities Law Concerning Nonpublic Information" (1985) 73 Geo LJ 1083 at 1091–1102; and Ramzi Nasser "The Morality of Insider Trading in the United States and Abroad" (1999) 52 Okla L Rev 377 at 377.

surveillance from the ASX to ASIC in August 2010, bringing a new focus on enforcement and regular publication of enforcement statistics.[108]

As outlined earlier, New Zealand has experimented with several distinct approaches to controlling insider conduct: purely private enforcement (1988–2002); private enforcement with an agency right of intervention (2002–2008); and the Australian criminal enforcement model (2008–present). None of these regimes has (as yet) been accompanied by decisive enforcement action that sends an effective deterrent signal to insiders. The question arising from these facts is why New Zealand's Parliament has legislated for these successive insider conduct regimes if indeed insider conduct has not been a serious priority for enforcement.

It has been well explained by "public choice" scholars that legislation is prone to serve private constituencies as well as the public interest. Recently, Joo has argued that legislators have an interest in the "self-legitimation" of their role by being seen to take action against perceived problems.[109] According to Joo's argument, legislation in the United States against insider conduct was substantially motivated by a desire to be seen to be taking action against identifiable "villains" behind the 1987 share market crisis. New Zealand legislators might have been moved to enact the 1988 regime by a similar desire to respond to public anxiety following the 1987 crash. It is also plausible that New Zealand legislators may have had regard to constituencies beyond their immediate electorate in New Zealand. Specifically, Parliament may have embraced the successive insider conduct regimes in order to be perceived as responsive to the expectations of American and Australian regulators or policymakers.

In response to the internationalisation of the world's securities markets, the SEC has vigorously promoted insider conduct regulation internationally, including by lobbying foreign governments to regulate:[110]

> In its Policy Statement issued in 1988, the SEC proposed the creation of a global market system by "minimiz[ing] differences between [countries'

108 Tony D'Alosio, Chairman of ASIC "Insider trading and market manipulation" (speech to the Supreme Court of Victoria Law Conference, Melbourne, 13 August 2010). The latest statistics on insider trading matters appear in Australian Securities and Investments Commission *ASIC supervision of markets and participants: January to June 2012* (Report 296, August 2012); and Australian Securities and Investments Commission *ASIC enforcement outcomes: January to June 2012* (Report 299, September 2012).

109 Thomas W Joo "Legislation and Legitimation: Congress and Insider Trading in the 1980s" (2007) 2 Ind LJ 575.

110 James A Kehoe "Exporting Insider Trading Laws: The Enforcement of US Insider Trading Laws Internationally" (1995) 9 Emory Int'l L Rev 345 at 351–352 (some footnotes omitted).

> regulatory] systems."[111] As is evident by its recent actions, the SEC clearly intends to minimize these differences between regulatory systems by implementing, on a global scale, securities regulations based on the US model. Specifically, the SEC stated that "[l]aws and regulations should promote efficiency and fairness in the securities markets by prohibiting such acts as insider trading … ."[112] In short, the SEC would like foreign countries to implement insider trading laws as strict as those found in the United States, resulting in the Americanization of the world's securities markets.

The enactment by other countries of laws to criminalise insider trading would be favourably perceived by influential American regulators (as "best practice") and would enable the SEC to take advantage of mutual assistance treaties when investigating cross-border insider trading violations.[113] In a setting in which a major trading partner is — partly for its own economic interests — advocating the enactment of more stringent regulation, it seems plausible that New Zealand legislators might adopt such laws, notwithstanding the absence of strong domestic public demand for such legislation or its enforcement.

Another explanation looks to the effects of the Closer Economic Relations (CER) Agreement with Australia that functions as an umbrella agreement for a set of downstream agreements with soft and hard law consequences.[114] One downstream outcome of the CER Agreement is the inter-governmental project to coordinate business laws in the two countries.[115] This project finds expression in the Memorandum of Understanding between the Government of New Zealand and the Government of Australia on Coordination of Business Law (Business Law MOU).[116] The Business Law MOU is soft law that has led to hard law consequences.[117] Pursuant to the Business Law MOU, New Zealand has adopted the Australian statutory regime on continuous disclosure and insider conduct. (Similarly, the Financial Markets Conduct

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111 US Securities and Exchange Commission *Policy Statement on the Regulation of International Securities Markets* Release No 33-6807, 53 Fed Reg 46,963 (21 November 1988) at 46,964.

112 At 46,965.

113 Kehoe, above n 110, at 352.

114 See Gordon Walker "The CER Agreement and Trans-Tasman Securities Regulation: Part 1" [2004] Journal of International Banking Law & Regulation 390.

115 See Walker, above n 114.

116 See Walker, above n 114 . The third and current version of the Business Law MOU was signed in June 2010.

117 See Walker, above n 114. Compare Chris Brummer *Soft Law and the Global Financial System: Rule Making in the 21st Century* (Cambridge University Press, Cambridge, 2012).

Act 2013 borrows heavily from the Australian Corporations Act 2001.) This borrowing from the Australian models serves the ends of business law coordination but does not necessarily result in legislation that fills perceived legal needs in New Zealand as the receiving jurisdiction. To elaborate, by adopting an Australian model of insider conduct prohibitions, New Zealand's business law became a degree better "coordinated" with Australia's; but since the law in New Zealand was enacted for the sake of the "coordination" project rather than to fill a locally felt legal need, it likely has not had the same domestic support behind it — nor public expectations of it — as a law motivated by domestic needs and demands. If we are right in this view, then there are interesting implications for legal transplant scholarship. One strand of the legal transplant scholarship stresses the need for customisation or tailoring of transplanted laws to meet the conditions of the host.[118] The Business Law MOU in the area of insider conduct regulation has arguably resulted in little customisation, apart from some technical changes. The resultant question is: does the Business Law MOU encourage or inhibit successful legal transplantation?

The insider conduct laws in place since 2008 are internationally credible, as they very closely resemble Australian law. They have not been modified in any meaningful way for local circumstances, however, and the impetus for their adoption seems to have had more to do with trans-Tasman coordination than filling a perceived domestic legal need. The fact that there has been no strong local demand for insider conduct laws or for enforcement should be no surprise. Since insider conduct laws in New Zealand do not express a popular sentiment of objection to that conduct but instead serve the different purpose of enhancing comity ("coordination") with our most important trading partner, the low enforcement priority accorded to insider conduct should not be wondered at and, indeed, is likely to continue to be a feature of financial markets law in New Zealand.

118 See Gordon R Walker and Alma Pekmezovic "Legal Transplanting: International Financial Institutions and Secured Transactions Law Reform in South Pacific Island Nations" (2013) 25 NZULR 560.