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Simpson Grierson

Corporate Advisory

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Insider Trading Laws - A Sea Change

A number of important changes are about to be made to New Zealand securities law. The Securities Markets Amendment Act 2006 (**Amendment Act**), which is to come into force on 29 February 2008, will amend the Securities Markets Act 1988 (**Act**) and includes far-reaching changes to insider trading laws, changes to the disclosure by substantial security holders, new market manipulation provisions and a general dealing misconduct provision, and new disclosure requirements for investment advisers and investment brokers.

In this, the first of a series of publications on the changes, we consider provisions relating to insider trading. Separate publications will be released to address other changes to the Act.

The new insider trading provisions strengthen the law relating to insider trading by adopting a regime similar to that in Australia and include criminal penalties for those found guilty of insider trading.

Background

The pre-29 February insider trading regime focuses on the fiduciary duties owed by officers or agents of a "public issuer" (an entity which is, or has been, party to a listing agreement with a registered exchange) to that public issuer, and the information obtained as a result of a person's relationship with a public issuer (the **fiduciary duty** rationale).

By contrast, the new regime focuses on the information an insider possesses rather than the position that they hold. The genesis of the new regime was a Cabinet paper published in July 2003. That Cabinet paper identified a number of problems with the current insider trading regime in the Act, including:

> "...the new regime focuses on the information an insider possesses rather than the position that they hold..."

- the requirement that a person can only be an insider if they directly or indirectly receive information through their relationship with a public issuer
- a lack of co-ordination with the Australian insider trading regime
- concerns that the existing regime is not effective
- inconsistencies in, and difficulties with interpretation of, parts of the Act (with Justice Fisher, in the High Court, criticising the language of the Act as "absurd" and noting that "it is difficult to escape the conclusion that the drafter of this unfortunate statute has nodded off again").

The new insider trading regime focuses on the threat that insider trading poses to the integrity and confidence of the market, rather than fiduciary duties. It seeks to emphasise the need to maintain market integrity by

ensuring that investors can participate on a level playing field (the **market efficiency** and **fairness** rationales).

Key Changes

The key changes to the legislation are:

- a policy shift towards harmonisation with the Australian insider trading regime, and a clear intention to improve both monitoring of insider trading behaviour and enforcement action against misconduct
- the removal of the need for an information insider to have a relationship with a public issuer, or to have obtained information through a person with such a relationship. The new regime looks at the nature of the information that a person possesses, rather than the position occupied by that person. As a result, a person who has material price sensitive information that is not generally available to the market is considered an information insider, regardless of that person's relationship with the source of the information
- the introduction of criminal liability for insider trading
- the introduction of new exceptions and defences to allegations of insider trading.

"...a person who has material price sensitive information that is not generally available to the market is considered an information insider..."

Core Prohibitions on Insider Trading

The central provision in the insider trading prohibitions require that an information insider must not:

- trade securities of a public issuer (section 8C of the Amendment Act)
- disclose inside information (section 8D of the Amendment Act)
- advise or encourage trading (tipping) (section 8E of the Amendment Act).

Key definitions under the new regime are:

- **Information Insider** – someone who has information about a public issuer that is not generally available to the market, where that person knows, or ought reasonably to know, that the information is material information and is not generally available to the market
- **Material Information** – information that a reasonable person would expect to materially affect a public issuer's share price if it were generally available to the market
- **generally available to the market** – information made known to or readily obtainable by persons who commonly invest in relevant securities (being securities which might reasonably be expected to be affected by the information).

Under the pre-29 February regime, someone is only an insider if they are an officer, employee, company secretary, substantial security holder, or receives confidential information from a person with such a relationship, of a public issuer. Someone who trades on inside information, but is more than two steps along the chain of communication, is not currently an insider.

By example, in 1999 a Fletcher Challenge employee acquired price sensitive information accidentally posted on an internal notice board, and forwarded that information to a relative who in turn forwarded that information to another relative. All three parties purchased Fletcher Challenge shares. The Securities Commission investigated and found that neither relative was an insider because the chain of liability under the Act stops at two steps from the public issuer. The Amendment Act removes the need for a link between the insider and the public issuer.

The meaning of "generally available to the market" (section 4 of the Amendment Act) is complex and rather uncertain. The Australian equivalent of section 4 has been widely criticised after it led to two contradictory outcomes in two cases on largely the same facts (*R v Firns* and *R v Kruse*).

Firns and Kruse both became aware of the outcome of a court case in Papua New Guinea, and used that information to purchase shares in the company which was the subject of the court case. When the court decision became public, it resulted in the shares Firns and Kruse had purchased increasing in value. Kruse received the information by sitting in the court gallery in Papua New Guinea when the decision was announced and he was acquitted on the grounds that the information was readily observable. Firns received the information in Australia by

telephone and he was convicted on the grounds that the information was not readily observable (although his conviction was overturned on appeal where the New South Wales Court of Appeal found the information was readily observable).

Although the "readily observable" test from Australia has been replaced by a "readily obtainable" test (section 4(1)(b) of the Amendment Act), in New Zealand information may be captured by more than one part of the section 4 definition. As a result, there is uncertainty as to when information is readily obtainable (for example, whether information that is only available overseas – such as in a court in Papua New Guinea – would meet the requirement).

Penalties

The new regime introduces a number of new penalties, as well as recasting existing sanctions. The suite of sanctions now includes:

- criminal liability (including maximum penalties of five years imprisonment or fines of up to $300,000 for individuals and up to $1 million for a body corporate) for a contravention of any of the core prohibitions of the Amendment Act
- management bans for up to 10 years
- compensation payments of up to three times any profit made or loss avoided.

"The new regime introduces a number of new penalties, as well as recasting existing sanctions."

Criminal liability only arises if an information insider is found to possess actual knowledge that the relevant information was material and not generally available to the market.

Exceptions and Defences

The new regime contains a number of exceptions and defences that are designed to reflect legitimate trading activity, including:

- where trading or information disclosure is required by law
- protection for underwriting agreements and sub-underwriting agreements
- a defence of knowledge of a person's own intentions or activities
- protection for an agent executing trading instructions only
- protection for information obtained by independent research and analysis
- an equal information defence, where both parties to a transaction knew or ought to have known the same information
- a defence of absence of knowledge of trading.

In addition, the current defence of trading where access to information is protected by Chinese walls will remain under the new regime.

Removal of Company Officers' Safe Harbour

The new regime removes the pre-29 February exception from action for insider trading for company directors and officers who trade shares within defined share trading window periods under an approved procedure (the **company officers' safe harbour** exception). The removal of this safe harbour is consistent with the focus of the new regime, which views insider trading as harmful to the market as a whole rather than mainly to the company involved.

Company share trading policies still have considerable value and, following the experience in Australia, will continue to focus on ensuring that trading is not conducted by directors and officers while they are information insiders. In addition, a defence from insider trading will be available where company directors and officers trade under a fixed trading plan that was entered into at a time when the director or officer did not possess any inside information. The trading plan must be for a fixed period and the director or officer cannot have any input into trading decisions during the applicable trading period (the **fixed trading plan** defence).

Whilst the substance of companies' share trading policies are unlikely to be materially affected by the new regime, it is likely that many such policies detail the effect of compliance with the share trading policy (by describing the impact of the company officers' safe harbour). As this will no longer be the case, share trading policies should be reviewed and, where appropriate, updated to reflect the new regime.

Looking Forward

Before the new regime takes effect, it is important that all public issuers, as well as directors, officers, investors and their advisers, understand its impact and its focus on maintaining market efficiency and fairness. Company directors and officers also need to understand the impact of the new regime's removal of the company officers' safe harbour, and how to qualify for the trading plan defence.

There seems little doubt that the Securities Commission will seek to take enforcement proceedings at the first opportunity. This will allow the Securities Commission to test its new powers and provide an appropriate signal to the market to reinforce its recent statements about its commitment to use those powers.

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