NEW ZEALAND BUSINESS ROUNDTABLE

SUBMISSION ON THE INSIDER TRADING DISCUSSION DOCUMENT

OCTOBER 2000

1 Introduction

1.1 This submission on the Ministry of Economic Development's September 2000 discussion document on Insider Trading is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand business firms. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 We have long regarded the existing legislation embodied in the Securities Amendment Act 1988 to be seriously deficient. No sound case was ever made for New Zealand's current insider trading law. Insider trading was not a general common law offence, in the United States at least.[1] The New Zealand law, in common with the law in overseas jurisdictions that it followed, wrongly assumes that the victim is the party trading with the insider. In fact those trading unknowingly with an insider will commonly benefit from the insider's activity. This is because they could have been expected to have to pay a higher price if buying, or receive a lower price if selling, were it not for the insider's trading.[2] Where unauthorised use is made of information, redress should be an issue between the rightful owner of that information and whoever misused it. Another way to illustrate this fundamental deficiency is to note that a law focused on making the act of trading an offence fails to capture those who use inside information in order not to trade when they would otherwise have done so. No legislation can be expected to be satisfactory unless its fundamental deficiencies have been addressed.

1.3 In our view, if the existing legislation is causing significant concerns, resources should be devoted to a 'back-to-basics' review of its entire rationale rather than to making amendments that preserve its unsatisfactory structure. The minister of commerce is reported to have said that a zero-based review would be "an excuse to do nothing for at least two years". This is hard to follow. First, a zero-based review is doing something. Second, all relevant alternatives should be considered if the

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1 See pages 860 and 883 in Dennis Carlton and Daniel Fischel, 'The Regulation of Insider Trading', *Stanford Law Review*, May 1983, pp 857-895.

2 The exception occurs where the trader would not otherwise have traded.

objective is efficient regulation. Third, the statement implies that there is a problem so urgent that something must be done immediately, even in the absence of a thorough analysis.

1.4 Section 2 of this submission considers what the government's objective might be if it is not efficient regulation. Section 3 reviews the evidence that there is a problem that is so urgent that something must be done even in the absence of a thorough-going review. Section 4 comments on specific items, including the discussion document's definition of insider trading and the issue of forced disclosure. Section 5 comments on the issue of compatibility with Australia. Section 6 presents some conclusions.

2 Policy objective

2.1 The ministry's covering letter of 5 September states that one of the government's key objectives is to promote confidence in the sharemarket. Given this objective, we would presume that the government would rely heavily on the opinions of the New Zealand Stock Exchange and its members on the source of any problems that relate to confidence. They must surely be more committed to this goal than any other group in the community. They are also surely the most knowledgeable about any problems of confidence.

2.2 Senior ministers and regulators have a responsibility to preserve and enhance the reputation of New Zealand's markets rather than to undermine them. Unfortunately, those in positions of authority pushed through the current insider trading regulations in 1988 under the catch-cry that New Zealand's markets were the last frontier of the Wild West, whereas in reality our laws were solidly based on longstanding English law. The prime minister's recent use of the same language to justify the adoption of the Takeovers Code was unfortunate in this respect.

2.3 For these reasons we think it is particularly important that proposals to modify securities laws be justified by a sound, rational public policy analysis rather than by unproven assertions about the need for yet more regulation.

3 Problem definition

3.1 The ministry's covering letter states that there is a perception in the market that the current regime is inadequate. Surprisingly, in the light of this claim, the discussion document makes no such assertion. Nor does the document provide any evidence that a problem of perceived undetected insider trading exists to a greater degree than occurs in other markets, let alone that any such difference is soundly based and material. Instead the discussion document appears to identify the problem to be that no person has yet been found liable for insider trading under the Act. The minister is reported to have expressed the same concern and concluded that "either New Zealanders are all lily-white and honest, or there is something wrong with the regime".[3]

3.2 We have asked the Ministry of Economic Development if there is any information that shows there have been more actions for insider trading in Australia than in New Zealand, on a scale-adjusted basis. We understand independently that there is a view in Australia that the number of prosecutions has been unduly low, perhaps because of the burden of proof. Possibly this legislation has generally proven to be difficult to make work. Carlton and Fischel commented in 1983 that insider trading regulations in many countries had either not been enforced or did not exist.[4]

3.3 We have also asked the Ministry of Economic Development for the information on which it based its assertion that there is a market perception problem. As already noted in section 1, market perception problems are bound to occur when leading officials and politicians promote new regulation by talking disparagingly about the integrity of the existing market, as occurred in 1988.

3.4 Perceptions that financial regulation is inadequate are surely insatiable. Black letter law as to what constitutes information given in confidence, what is price sensitive information, and who is an insider, is inescapably troublesome. There will always be those who will argue that the trade-offs have been drawn too loosely. Others will have an irreducible perception that regulation is inadequate unless it ensures that all are equally informed. This is hopelessly utopian, but the

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3 *New Zealand Herald*, 28 September 2000.
4 *Op cit*, p 860.

view will probably always exist. Then perceptions that law is inadequate will always arise because of international differences in regimes. Some of those who are accustomed to highly intrusive regimes and comfortable with them will inevitably view behaviour in countries with less intrusive regimes as evidence that those regimes are inadequate. We have seen this in relation to the debate on the takeovers code. Such demands for additional regulation surely mean that the existence of negative perceptions should never be taken as proof that further regulation will do more good than harm. There can be no substitute for scrutiny and analysis of such perceptions.

3.5 Our consultant has made some informal inquiries amongst local market professionals to uncover their perceptions about insider trading in New Zealand. The evidence that New Zealand is perceived to have an insider trading problem *relative to other countries* appears to be tenuous.[5] The evidence that any such perceptions are soundly based appears to be even weaker. We have asked the chief executive of the New Zealand Stock Exchange if the Stock Exchange perceives insider trading to be a real problem, as distinct from a perceived problem. We understand that it doesn't. A very experienced local broker in a major investment bank has commented that the internal rules within major international investment banks are so stringent that undetected insider trading by any staff member is virtually inconceivable. Colleagues in a major local law firm expressed concerns about imbalances in information, briefings of analysts, perceptions that stories do exist of individuals who 'push the limits', but none stated that they saw it as a major problem or that New Zealand stood out in this respect. A related suggestion was that company officers in a target company that was not experienced in dealing with takeover offers, and therefore less alert to the need for proper processes and sound security systems, might be more likely to succumb to the temptation to trade improperly. One major fund manager said that he was not aware of any concerns that insider trading was a particular concern with the New Zealand market. However, one local professional fund manager did say that he knew of some investors in the United States who were concerned about the possibility of

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5 A couple of professionals commented that the Force Corporation case had created negative perceptions, but they did not claim that it made New Zealand stand out in this respect or did not appear to have a clear view on whether the problems arose from weaknesses in the legislation or in its enforcement.

unreported trading by New Zealand directors. Presumably boards would change their rules about trading by directors were these concerns sufficiently important.

3.6 Another possible source of concern stems from academic research that typically finds that share prices tend to move in advance of a significant company announcement. However, we are not aware of any research that finds that New Zealand stands out in this regard. Share prices that are 'strong form efficient' should, by definition, incorporate information before it is publicly disclosed. Such impounding of information could occur because of proper or improper insider trading, loose talk, or intelligent guesses by trained or untrained outsiders. Loose talk is more likely closer to an announcement, as more people become involved. But markets can anticipate pending announcements even in the absence of loose talk or improper trading. A company's officers can be asked any day of the week about how their company is doing by friends, associates, advisers or potential advisers, suppliers, customers, analysts, journalists and others. Professional analysts and financial journalists are expected to be the first to nose out important new information. When a major announcement is pending, company officers and directors face an uneviable dilemma: they can lie, evade, or, if the request is not face to face, go to ground. The first is not tenable for any reputable company. The second and third signal to the actual or would-be questioner the possibility that something could be going on. Even a failure to return a journalist's calls about a rumour will be information. There may be no neutral position.

3.7 None of this is to argue that New Zealanders are any more or less 'lily-white' than anyone else. Inevitably, some will attempt from time to time to put inside information to improper use. Many more will just talk indiscreetly. This is human nature. Any view that more regulation can *eliminate* the improper use of information is simply utopian. By the same token, as already noted, no amount of regulation can hope to dispel perceptions that insider trading is a problem. No one can prove that what is undetected does not exist.

3.8 The only sound way to proceed would be to establish that there are material perception problems *and* that they have a foundation in reality. Those putting forward the current proposals have failed to do either.

3.9 Both the discussion document and the minister's reported comments make unequivocal and unsubstantiated assertions about the materiality of possible 'gaps', including the costs of private legal action. As it happens, the executive director of the New Zealand Business Roundtable is currently taking legal action on an insider trading case in a private capacity. Officials have not consulted him about the costs of this well-publicised action. If they had done so he would have been able to tell them that they are not so high as to present any formidable obstacle, even to an ordinary investor. What then is their authority for asserting in paragraph 1.5 of the discussion document that such costs "all act as significant barriers for individuals in taking an action"?

4 Analysis of the alternatives

4.1 The only alternatives considered are those based on closing perceived gaps, taking the existing framework as given. The minister's reported comments implicitly acknowledge that the regime might itself be fundamentally at fault, but immediately rule out the option of investigating that possibility.

4.2 The discussion document adopts an extraordinary definition of insider trading, namely trading in securities with the benefit of information that is not publicly available (paragraphs 1.9 and 4.1). Such a definition would appear to potentially preclude all trading since the public does not know the reservation prices of each buyer and seller. Nor is the product of the research conducted by professional investors for their own purposes in the public domain. This definition is so bizarre as to undermine confidence in the discussion document as a whole, thereby creating doubts about the value of attempting a full response and the soundness of any decisions that finally emerge.

4.3 The document provides no framework whatsoever for considering the desirability of preserving incentives to invest in information and the ability of shareholders and managers to contract for the allocation of property rights in company information. Specifically, it does not consider the option of letting stock exchanges and companies determine their own rules about share trading by directors and staff. Richard Epstein has provided an insightful analysis of the contemporary

conflict between forced non-disclosure (eg a Privacy Act) and forced disclosure.[6] He discusses the specific case of insider trading and makes the point that no major externalities are involved.[7] Shareholders can readily vote to determine what rules should apply, company by company. They would not have needed to wait for the Securities Amendment Act 1988.

4.4 Forcing the disclosure of information has obvious benefits to those whose privacy is not at stake and who have not got a possibly significant portion of their wealth tied up in shares in a company.[8] But there are costs to this exaction, as with any other confiscation of wealth. It could become more costly to recruit directors and staff and more difficult to incentivise them. Share prices may be less efficient. For example, trading by directors may be inhibited even when false rumours are circulating that trading by directors might serve to dispel.

5 Compatibility with Australia

5.1 The document asserts at paragraph 1.13 that there are obvious advantages from coordinating New Zealand and Australian law. While it fails to consider any disadvantages, it does state that it would welcome submissions on the appropriateness of Australian law being adopted in New Zealand. We submit that there is no substitute for a thorough and rigorous analysis of the net benefits of any proposed regulations for New Zealanders. We are not aware of any expert body of opinion that holds Australian regulations in high esteem in an international context. Competition between regulatory regimes is desirable, as the example of the states within the United States illustrates. If New Zealand wants companies to locate in New Zealand rather than Australia, based on comparative advantage, it should seek to ensure that its regulations are efficient.

5.2 The economic literature on regulation has established that regulations are commonly introduced for the benefit of interest groups, often the regulated

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6 Richard Epstein, *The Concealment, Use and Disclosure of Information*, New Zealand Business Roundtable, August 1996.

7 *Op cit*, pp 17-18. See also the Carlton and Fischel article cited above.

8 The "Shake-up needed" article by Brian Gaynor, *Weekend Herald*, October 7-8, 2000, considers only such benefits, ignoring entirely the costs of forced disclosure rules.

industries, rather than for the benefit of the public at large.[9] Adopting Australian regulations implies adopting the set of regulations that emerge from Australian political processes. These may not give much weight to any characteristics that make the New Zealand market different from that in Australia. Indeed, some lobbyists may desire to grow the Australian market at the expense of the New Zealand market. This is not an argument about allowing market institutions to merge; it is an argument against allowing another parliament to determine what regulations New Zealand will adopt.

5.3 Globalisation is another factor to take into account. Australia is only part of a wider picture. Arguably New Zealand governments are going to have a diminishing influence over the regulatory environments that affect production in New Zealand. As New Zealanders invest globally, more New Zealand assets will be owned by foreigners. Major overseas firms are likely to apply the same professional standards to the New Zealand market that they are accustomed to applying in their home markets. Similarly, New Zealand firms should find it increasingly practicable to raise capital and to list on overseas markets. The less efficient are New Zealand's regulations, the quicker such effects will be felt.

6 Concluding comment

6.1 Perhaps reflecting a predetermined approach by the government to the issue, the discussion document fails to raise the fundamental problem with this legislation that we summarised in paragraph 1.2 above. It is hard to see that any amendments to this legislation can prove to be satisfactory while these flaws remain. We suggest that the ministry survey the experience overseas with legislation of this type to establish if there is any jurisdiction in which its troublesome nature is not in contention.

6.2 Putting this question to one side, the original legislation failed to create any clarity about what constituted information given in confidence and what constituted price sensitive information. It clearly impeded legitimate activities while not obviously impeding improper activities. The existing legislation was likely to be draconian if

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9 See for example pp 10-11 and 326 in *Economics of Regulation and Antitrust*, second edition, W Kip Viscusi, John M Vernon, Joseph E Harrington, MIT Press, 1998.

vigorously enforced, or ineffectual (and thereby relatively harmless) otherwise. The current proposals seem to risk shifting it towards the former extreme. It is difficult to contemplate anything more extreme than the definition of insider trading in paragraph 4.1 of the discussion document.

6.3 From a public policy perspective, the ministry's current analysis fails to establish that the alleged adverse market perceptions warrant the adoption of the proposed measures. It even fails to establish the source of any such perceptions – such as the failure of politicians and regulators to adequately defend markets, profits or even capitalism against ill-informed populist attacks. One might as well argue that there is a perception that profits are bad, therefore all profits should be regulated. There is no attempt to ascertain whether what is proposed will actually alter negative perceptions.

6.4 As a practical matter, we are discouraged from putting more resources into this submission because it seems that the government's mind is made up. We believe that far from increasing confidence in the sharemarket, the government will simply exacerbate perceptions that it is hostile to business and is not prepared to undertake or listen to any proper public policy analysis of its proposals.

6.5 We submit that the government should insist on a competent and rigorous analysis of the proposals in the discussion document and the existing legislation before taking any decisions.