NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Securities Legislation Bill

February 2005

1. Introduction

1.1 This submission on the Securities Legislation Bill ('the Bill') is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The Bill's explanatory note describes it as an omnibus bill. It will amend the Securities Act 1978, the Securities Markets Act 1988, the Takeovers Act 1993, and the Takeovers Code, with related amendments to other statutes. The government anticipates dividing the Bill into three separate bills: a Securities Amendment Bill, a Securities Markets Amendment Bill, and a Takeovers Legislation Amendment Bill.

1.2 The NZBR has had a longstanding interest in securities market regulation. One of our major and ongoing concerns has been the lack of rigorous analysis of either the alleged problems or the likely efficacy of proposed remedies.[1] All too often costly and ineffectual legislation has been introduced with little more to justify it than irresponsible 'Wild West' rhetoric.

1.3 The current Bill results from the Securities Trading Law Reform project undertaken by the Ministry of Economic Development. We made a submission in August 2002 on the three volumes of discussion documents on the *Reform of Securities Trading Law* that comprised the major part of this work. In it we expressed our concerns about the low quality of the regulatory analysis in these documents and our lack of confidence in the Ministry's process.[2] The annex to this submission contains the key points we made in this submission.

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1 See 'Submission on the Review of the Securities Commission', New Zealand Business Roundtable, February 1998 for a lengthy discussion of these concerns.

2 'Submission to the Ministry of Economic Development on the Reform of Securities Trading Law', August 2002, (http://www.nzbr.org.nz/documents/submissions/submissions-2002/insider_trading.pdf).

1.4 As a result of the Ministry's review, policy papers were submitted to Cabinet in July 2003. These were accompanied by a full set of Regulatory Impact and Business Compliance Cost Statements. A subset of these statements is included in the current Bill. We have been advised that regulatory statements on the insider trading, market manipulation and penalties and remedies provisions were not included in the Bill on the grounds that it was not technically necessary to include them because these provisions were not found to impose compliance costs on businesses. Compliance costs, however, are only a part, and usually a small part, of the overall economic costs of a regulation, and the purpose of the Cabinet requirement for Regulatory Impact Statements is to evaluate the overall net benefits of legislation and regulations. Given that at least one major law firm[3] sees the changes to the insider trading regime as being the Bill's "centrepiece", we suggest that in its report on the Bill the committee should criticise the grounds for not providing an RIS. In this submission we examine the July 2003 RISs as well as those in the Bill.[4]

1.5 Section 2 of this submission assesses whether the provisions in the Bill are justified by the analyses contained in the relevant RISs. Section 3 presents our conclusions and recommendations.

2.0 Analysis of the provisions in the Bill

The Bill's objective

2.1 The Bill's explanatory note states that it is "designed to ensure confidence in, and promote the efficiency of, New Zealand's capital markets by increasing the effectiveness of securities, securities trading, and takeovers laws". It offers no measure of the level of confidence sought by the government and no analysis of why measures that might increase the 'effectiveness' of these laws could be expected to increase capital market efficiency or confidence. An

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[3] Buddle Findlay, 'Securities Legislation Bill Update', December 2004, p 1.

[4] We note that the RISs that are included in the Bill follow the 24 July 2003 versions very closely.

obvious concern here is that attempts to enforce poor quality legislation could defeat both objectives.

Does the Bill address real or imagined problems for investors?

2.2 In respect of *insider trading*, the then minister of commerce explained in introducing the Bill that the current (statutory) laws are complex and difficult to enforce. Regrettably, this is true: we criticised them at the time they were proposed and it is pleasing to see this acknowledgement. In our view the current laws amply illustrate the folly of introducing unsound legislation on the basis of mantras (the 'Wild West' in this case), or nostrums such as 'promoting confidence'. The RIS points to research that finds that countries that have effective and enforced regimes will achieve more liquid markets. However, New Zealand's existing regime appears to score highly on this measure, so such research may not indicate that more is better.[5]

2.3 In respect of *market manipulation,* the Bill provides no evidence of a problem. The July 2003 RIS confirms that there is no empirical evidence that the problem exists, but asserts that market manipulation is "widely regarded" as occurring in New Zealand. It makes no attempt to clarify what definitions of market manipulation lie behind such alleged perceptions. Nor does it consider whether such reported perceptions might reflect self-interest, or misinformation about the 'Wild West'.

2.4 In respect of *investment adviser and broker law*, the Bill asserts that current statutory law is "ineffective in providing investors with all the information they need to make informed investment decisions". Since the future will always be uncertain, this criticism is utopian.

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[5] Laura Beny, 'Do Shareholders Value Insider Trading Laws? International Evidence', Harvard Law School Discussion Paper No 345, December 2001 reports in table 2, p 43 that New Zealand's insider trading regime scored in the top 4-5 bracket category (out of a maximum score of 5), along with Australia and the United States. The score for the United Kingdom, Switzerland, Germany, Sweden and many others was 'only' a three.

No legislation can ensure investors are supplied with perfect information. However, the RIS in the Bill does identify, from a regulator's viewpoint, six concrete problems with the existing legislation. On the issue of whether any of these are also a real problem for investors, it points to public complaints to the Securities Commission about investment advisers; sums of money lost through illegal schemes promoted by local investment advisers; and a lack of awareness of statutory entitlements and requirements. While it is pleasing to find a RIS that actually uses some verifiable data, it is only of a preliminary nature. For example, the statement does not provide any benchmark for determining the optimal level of complaints or sales of illegal products. (It thereby invites readers to adopt the utopian benchmarks of zero in each case.) Nor does it ask whether it is the losses that concern investors most rather than the technical legality of the original investments.

2.5 In respect of the *application* of existing laws to (1) takeovers of companies with at least 50 members but with assets of under $20 million; (2) futures markets; (3) the territorial application of investment adviser provisions; and (4) non-quoted securities of public issuers, the RIS in the Bill does raise (in our view reasonably) the question of whether the costs of administering and complying with the current distinctions in respect of (1) and (4) exceed the benefits. In respect of (2) – applying the insider trading and proposed market manipulation provisions to behaviour on authorised futures exchanges – it asserts that there is a "potentially large" problem and that failure to address it could reduce domestic and investor confidence in these markets. It makes no attempt to dispel the impression that the ‘problem’ may be little more than a regulator's fantasy. In respect of (3), there is again no statement of any actual problem for investors. Instead, there appears to be a regulator's concern that there could be "significant damage to New Zealand's international reputation in the investment markets, and to individual New Zealanders" unless New Zealand investors are denied unfettered access to advice from overseas-based professional advisers.

2.6 All in all this is a disappointing assessment. We find ourselves in agreement with the following editorial comment:

> More regulation of the financial markets, in the form of the Securities Legislation Bill, is confirmation the government is reacting to a problem more of its own imagination than the reality. No Enron-style scandals have occurred here and there is a high degree of investor confidence in the market, as the share indices indicate. This is not due to a raft of new laws.[6]

Are the proposed measures likely to solve any actual problems?

2.7 The proposed insider trading legislation represents a fundamental change. It is based on Australian law and the notion that insider trading is a threat to "market integrity" rather than a breach of duties owed to a company. Will it meet its professed objectives? We are doubtful. Imposing criminal penalties may in fact make it harder to achieve prosecutions, even if it is assumed that this would be in the public interest. In a Bell Gully assessment:

> While it is true that the current laws are complex, the proposed new laws are undoubtedly more complex. Whether they result in more convictions or findings of liability will remain to be seen.[7]

2.8 How successful has Australian insider trading law been in getting convictions? According to one source, Rene Rivkin is the only person to be jailed in a decade and there have been only five successful prosecutions for insider trading.[8]

2.9 The Bell Gully assessment also notes that the proposed measures will extend potential liability to a much wider group of investors. The measures rely on imprecise concepts such as "material information", "material effect on price", and what a non-expert "reasonable person" might expect. There also appears to be a problem in allowing a claim for loss of value even if the share price has not changed.

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6 *National Business Review*, 30 November 2004.
7 Bell Gully, *Corporate*, December 2004, p 1.
8 *The Independent*, Catriona MacLennan, 'Tougher Market Regulation', 16 December 2004.

2.10 If we add to all these uncertainties the potential for up to five years imprisonment and fines of up to $300,000 for an individual, it is not difficult to imagine such measures having a chilling effect on transactions in shares by well-informed investors. Share prices could become less efficient as a result. Share market liquidity could fall rather than rise. Similar fears arise in respect of the market manipulation measures.

2.11 A submission in 2003 by the Commercial Law Association of Australia expressed similar fears in the context of Australian insider trading law as follows:

> There is a danger with the complexity and breadth of the Corporations Law that the ability of even moderately advised persons to understand the law and its application is significantly compromised. The danger is that the introduction of complex provisions to prevent avoidance or so that exceptional examples of egregious conduct are caught, will mean that conduct will be rendered illegal which would not reasonably be expected to be. It is a dangerous principle that any overreach of the law can be rectified by prosecutorial discretion. Such an approach leaves potential defendants uncertain of the extent of their obligations and can amount to a system of selective law enforcement at the whim of the regulator. In the absence of a clear compliance line, the more prudent may be unduly limited in their commercial activities.[9]

2.12 The Ministry of Economic Development's RISs fail, almost across the board, to identify such potential costs. Specifically, the statements of the net benefit in the RISs for insider trading; market manipulation; penalties and remedies; investment advisers; and substantial security proposals do not draw attention to the possibility of any unintended and unwanted costs. For example, the statement of net benefit for the insider trading regime simply asserts that the regime will produce all the hoped-for benefits and states starkly:

> No costs have been identified with the regime for investors or public issuers.

We submit that such an approach is mere advocacy. Ministers cannot be expected to take informed decisions if the public sector

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[9] Commercial Law Association of Australia, Legislative Review Task Force, 'Submission to Corporations and Markets Advisory Committee Insider Trading Proposal Paper', November 2002, http://www.camac.gov.au/camac/camac.nsf/byHeadline/PDFSubmissions/$file/ CLAA_ Legislative_Review_Task_Force.pdf.

will not advise them of the possible adverse consequences of those decisions.

Have ministers been adequately advised about alternative courses of action?

2.13 The Ministry of Economic Development's own guidelines for departments in preparing RISs specify that ministers should not be deprived of information about relevant alternatives by the choice of a policy objective that is so narrow as to prejustify the preferred alternative. Again, almost without exception, the RISs in question violate this requirement.[10] Specifically:

- the insider trading RIS states that: (1) "No non-regulatory options were considered as there were no non-regulatory options that addressed the public policy objective"; (2) "Maintaining the status quo … does … not achieve the public policy objective"; and (3) "No other options [to the preferred option] were considered as this option met the public policy objective";
- the market manipulation RIS states that: (1) "maintaining the status quo does not achieve the policy objective …"; and (2) "No other options [than the preferred option] were identified to achieve the desired objective";
- both the penalties and remedies RIS and substantial security holder RIS identified three options including the status quo, but ruled out two of them "because they do not achieve the policy objective" or because they do not "further the policy objective"; and
- the overview-application RIS simply states that "No other regulatory options were considered feasible because the problems identified are narrow in their scope … ".

2.14 In short, these RISs have defined the objective so narrowly in each case as to give ministers no opportunity to appraise alternative

[10] One exception is the investment adviser RIS. It leaves open the option of occupational licensing.

courses of action that might better meet the Bill's overall objective (see paragraph 2.1 above). One obvious alternative in respect of insider trading is shareholder decisions about the rules to apply.[11]

2.15 Overall, we conclude that the RISs do not adequately advise ministers or the select committee about whether the problems this Bill addresses are important to investors, will be satisfactorily addressed by the measures in the Bill, or are superior to relevant alternatives.

3.0 Concluding comments

3.1 The analysis in section 2 confirms the criticism we expressed in our 2002 submission (see the annex) about the quality of the Ministry's approach and analysis. The RISs provided in support of the measures in the Bill are statements of advocacy, not analysis. They do not give an impartial professional assessment of the issues, make a farce of the Ministry's own guidelines, and fail to meet the requirements in the Step by Step Guide to the Cabinet Manual.

3.2 We do not see how the government, or parliament, can make quality decisions if they do not receive quality advice. We note the irony that the measures in the Bill set very high standards for investment advisers and brokers who are convicted of a breach of the regime. They include banning orders of up to 10 years for serious offenders. Investment advisers and brokers could be forgiven for asking about the comparable sanctions for policy advisers.

3.3 Our greatest concern is that the measures in the Bill, taken as a whole, may have a chilling effect on legitimate investors and reduce the efficiency and liquidity of New Zealand capital markets. We see a risk that the regulators, keen to prove that they 'have teeth' under the new legislation, may choose their victims unwisely, confirming

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[11] See Richard Epstein, *The Concealment, Use and Disclosure of Information*, New Zealand Business Roundtable, 1996.

the investment-deterring effect of these measures. Another risk is that the legislation will prove too difficult to enforce effectively, inviting 'regulatory creep' in the form of further regulatory attacks on investors' freedom of contract and choice.

3.4 We recommend that in considering its report to the House, the committee should pay particular attention to the burden of proof. Parliaments should not legislate to raise investors' costs and restrict their options except for a good public policy reason. The onus of proof therefore falls on the advocates of the proposals in the Bill.

3.5 On our analysis the main advocates appear to be the regulators. The incentives of regulators are likely to be less well aligned with the interests of investors than the incentives of investment advisers and brokers in a competitive market. This is because investors are not paying the regulator's bills directly and regulators enjoy a statutory monopoly in respect of any services they are rendering to investors. Where a Bill would also increase the regulators' budget, as is the case in this instance, the potential conflict of interest is increased. These points serve to emphasise the importance of the issue of the burden of proof.

3.6 Internationally, there is growing concern that reactions to demonstrated examples of corporate wrongdoing, such as the so-called Sarbanes-Oxley legislation in the United States, have overreached and unjustifiably raised costs to firms and investors. There has been a trend to ‘going private’ to escape the regulatory costs of public markets. In New Zealand there have been no examples of similar misconduct, and excessive regulation would reduce the attractiveness of public company listings. Some companies have avoided listing on the regulated NZX exchange in favour of an alternative exchange, Unlisted, which has lower transaction costs. Now the government is considering regulation of Unlisted. We see this regulatory dynamic continuing with further efforts to regulate public markets – investors will always seek lower cost alternatives. Following Australian practice in this area is highly

questionable. Australia's system of securities law is one of the most expensive in the world, and there is no evidence that it has improved market integrity.

3.7 Select committees have a duty to insist on rigorous justification of government proposals, by way of competent Regulatory Impact Statements where relevant, before sanctioning the adoption of bills. The RISs provided to date on the Securities Legislation Bill are sub-standard. We recommend that the Bill should not proceed until a better quality analysis has been provided to the committee and submitters have a further opportunity to comment on it.

ANNEX

Key Points Made in August 2002 on the Reform of Securities Trading Law[12]

The key points made in this submission were that:

- there are many actions that the government could take in support of its goal of increasing confidence in the New Zealand sharemarket;
- the proposed regulatory approach and dynamic seems likely to make New Zealand's capital markets less liquid and less competitive. In our view the Ministry should take this concern very seriously;
- the documents effectively assume the efficacy of further regulations that ostensibly address a problem that may not exist in the pursuit of an objective that is not measured, and for which no measure of success is proposed;
- the presumption that confidence in the market can be improved by passing further legislation seems unwarranted. First, an attitude of legality could replace rather than complement an attitude of morality. Secondly, bad law penalises the law-abiding and brings the law into disrepute;
- the so-called 'fundamental review' of our insider trading legislation is not a fundamental review;
- the proposals for the regulation of market manipulation fail to identify the problem adequately and appear to have the potential to markedly reduce the liquidity of New Zealand markets;
- the government's key priority for capital market 'reform' (ie further regulation) appears to lack a sound basis and to be at odds with the priorities that the Ministry ascertained from experts in the field when it first took responsibility for securities market legislation;
- we look to the Ministry to set high standards for regulatory analysis. A useful test of the quality of existing and proposed securities legislation is whether it is, or could be, supported by independent,

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12 'Submission to the Ministry of Economic Development on the Reform of Securities Trading Law', New Zealand Business Roundtable, August 2002.

professionally competent RISs. None of the legislation that is the focus of the current discussion documents appears to fall into this category; and

- we have no confidence in the process the Ministry appears to be following to finalise its views on these matters. Public policy analysis should not be about counting sometimes ill-informed and self-serving heads on matters that require a solid factual basis and professional analysis. If the Ministry wants submitters to commit significant resources to making submissions, it needs to give more thought to how it can better signal that facts, reasoning and serious professional concerns will be taken seriously.