"You're a bad boy but thanks":[1]

A Critical Analysis of New Zealand's Insider Trading Regime

Tommy Brennan

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[1] [*Sic*]. Texted by Hamish Sansom to Jeffrey Honey after receiving inside information. See *Financial Markets Authority v Honey* [2017] NZDC 12793 at [18].

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List of Abbreviations:

FMA: Financial Markets Authority.
FMCA: Financial Markets Conduct Act 2013.
IOSCO: International Organisation of Securities Commissions.
NYSE: New York Stock Exchange.
SAA: Securities Amendment Act 1988 (as enacted).[2]
SEC: Securities and Exchange Commission (USA).
SMA: Securities Markets Act 1988.[3]

Refer to the timeline at Appendix I for more detail as to the differences between the SAA, SMA and FMCA.

[2] The Securities Markets Amendment Act 2002 renamed the SAA the Securities Markets Act 1988. However, in this dissertation "SAA" will refer to the fiduciary-based insider trading prohibition that existed under the SAA (and after 2002, the SMA) until the 2006 introduction of a market fairness regime.

[3] As amended by the Securities Markets Amendment Act 2006, which implemented the market fairness regime. See the timeline at Appendix I.

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"Our era aptly has been styled, and well may be remembered as, the "age of information." Francis Bacon recognized nearly 400 years ago that "knowledge is power," but only in the last generation has it risen to the equivalent of the coin of the realm. Nowhere is this commodity more valuable or volatile than in the world of high finance, where facts worth fortunes while secret may be rendered worthless once revealed."[4]

[4] Judge Irving Kaufman waxing lyrical in *SEC v Materia* 745 F 2d 197 (2d Cir 1984) at 198.

Introduction

Perhaps no aspect of securities market law animates public interest to quite the same extent as insider trading. Arguably the quintessential white-collar crime, insider trading has an enduring presence in popular culture: cases about it attract publicity, shows and films centre entire plots on fictional characters engaging in it, and regulators loudly condemn it.

On the international stage, New Zealand has attracted criticism for weak enforcement of its insider trading prohibition:[5] one conviction and a smattering of settlements and enforceable undertakings comprise the domestic enforcement record since prohibition officially commenced in 1988.

At first glance, enforcement seems an easy criterion by which to gauge the efficacy of New Zealand's insider trading regime. However, I do not consider enforcement to be an appropriate basis for measuring the regime's success given that the true extent of insider trading in New Zealand is inherently unknowable. This dissertation will analyse the suitability of New Zealand's current insider trading regime in terms of internal and theoretical coherency by reference to historical and international jurisprudence. New Zealand's enforcement record merely forms part of the backdrop to this inquiry.

In Chapter 1, I examine the current law in detail. New Zealand's former statutory regime and the Australian jurisprudence provide rich sources of comparative material that are employed to demonstrate the strength of the current law. In Chapter 2, I endeavour to provide a sound moral and economic justification for the regulation of insider trading, upon which the subsequent jurisprudential analysis can proceed: Chapter 3 critically explores the market fairness and fiduciary rationales for insider trading prohibitions and concludes that market fairness is most appropriate to the New Zealand context. Broadly, this rationale holds that investors are entitled to obtain and evaluate information on the same footing as others in the market. Chapter 4 draws my analysis together into a coherent and brief critique; ultimately, I conclude the New Zealand regime is robust and suitable for the domestic context.

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[5] Gordon R Walker and Andrew F Simpson "Insider Conduct Regulation in New Zealand: Exploring the Enforcement Deficit" (2013) 3 NZ L Rev 521 at 536.

Before my substantive analysis can proceed, some context is necessary. Within the financial system, capital markets facilitate the buying and selling of long-term financial products,[6] which may be equity securities, debt securities, managed investment products or derivatives.[7] Broadly, capital markets bring together investors with surplus capital and companies seeking capital through the issuance of financial products on the primary market that can then be traded between investors on the secondary market. As a corollary, capital markets facilitate diversification and transfer of risk as well as the raising of capital.[8] The capital markets share a symbiotic relationship with the banking system, but each exists as a distinct part of the financial system.[9] This dissertation is principally concerned with the secondary markets for equity, debt, and derivatives as it is to these the prohibition of insider trading relates.

Public capital market activity in New Zealand takes place through an exchange ("the NZX") owned and operated by NZX Ltd ("NZX"), which was incorporated in 2003 following the demutualisation of the New Zealand Stock Exchange and is itself a listed issuer.[10] NZX is the only domestic financial product market operator licensed under the Financial Markets Conduct Act 2013 ("FMCA"), although the statute does not contemplate any limit to the number of licensed exchanges.[11] The FMCA is an omnibus statute that among its many functions establishes the legislative framework which prohibits insider trading and within which the NZX must operate. The New Zealand capital markets are characterised by a small total market capitalization and high institutional ownership.[12] Recently, the NZX has suffered from a dearth of equity listings that future policy is directed at addressing.[13]

The insider trading prohibition in the FMCA concerns trading in financial products: the financial products of "listed issuers" that have listed equity or debt on the NZX, or derivatives. Before a company is eligible to list on the NZX, it must satisfy certain requirements

[6] On the other hand, short-term financial products are traded on the money markets. See: Warren Potter "An overview of the money and bond markets in New Zealand" (1995) 58 3 Reserve Bank Bulletin at 177.
[7] FMCA, s 7.
[8] Lauren Rosborough, Geordie Reid and Chris Hunt "A primer on New Zealand's capital markets" (2015) 78 Reserve Bank Bulletin at 4.
[9] The banking system involves banks holding financial assets on behalf of customers and the further leveraging of those assets to fund lending to firms and the public.
[10] Geof Mortlock "New Zealand's financial sector regulation" (2003) 66 4 Reserve Bank Bulletin at 47.
[11] FMCA, s 315.
[12] Rosborough, Reid and Hunt, above n 8, at 11.
[13] Capital Markets 2029 Working Group "Growing New Zealand's Capital Markets 2029" (9 September 2019) at 19.

promulgated by NZX, such as a minimum market capitalization of $10 million and a mandated minimum investor spread. If these requirements are met, a company may list through either an Initial Public Offering ("IPO") or a compliance listing; the distinction being that an IPO involves the issue of new shares to raise additional capital for the company, while a compliance listing involves listing shares without any capital raise occurring. Globally, there has been a recent trend towards compliance listings.[14] Alternatively, a company may choose to list debt on the NZX debt market subject to specific governance requirements.[15] Regardless of whether equity or debt is being listed, the listing company must seek approval from NZX's Issuer Compliance division and meet all relevant internal and external requirements as mandated by NZX and the FMCA. Once these requirements are satisfied, the listing can proceed: relevantly, this involves the company in question becoming party to a Listing Agreement with the NZX. Once a company is party to such an agreement, it is deemed a "listed issuer" under the FMCA, and thereafter must comply with the NZX Listing Rules.[16] The listed issuer's financial products listed on the exchange are deemed "quoted financial products" under the FMCA.[17]

The NZX also falls within the regulatory ambit of the Financial Markets Authority ("FMA"). The FMA has responsibility for monitoring NZX's compliance with its general obligations in respect of its licence.[18] Furthermore, the FMA has regulatory oversight over all activity on the primary and secondary markets and accordingly is the regulatory body charged with enforcement of the insider trading prohibition.

The FMA was established as a Crown Entity in 2011 in response to "increasing concerns about the quality of enforcement in securities markets" and fragmentation of regulatory agencies.[19] Its statutory objective is "to promote and facilitate the development of fair, efficient, and transparent financial markets".[20] To that end, the FMA is responsible for enforcing securities markets, financial reporting and company law as they apply to financial markets in New

[14] Capital Markets 2029 Working Group, above n 13, at 16.
[15] The requirements of a regulated offer of debt securities are found at s 103(1) of the FMCA, and the NZX's ongoing duties in relation to debt securities are found at ss 114-118.
[16] FMCA, s 6. Compliance with the Listing Rules is also a condition of the Listing Agreement with NZX.
[17] FMCA, s 6.
[18] FMCA, ss 337-342.
[19] Cabinet Paper "Creating a Financial Markets Authority and Enhancing Kiwisaver Governance and Reporting" (April 2010).
[20] Financial Markets Authority Act 2011, s 8.

Zealand.[21] The FMCA equips the FMA with a variety of powers to this end, which shall be addressed in my analysis of the enforcement of the regime. Given that the current iteration of New Zealand's securities regime is relatively new, it bears noting that the FMA incorporates the functions of the old Securities Commission within its broader function.

Chapter 1: The status quo

Insider trading prohibition under the Financial Markets Conduct Act 2013

New Zealand's insider trading law is principally set out in Part 5 of the FMCA. New Zealand's first insider trading regime was enacted by the Securities Amendment Act 1988 ("SAA"), which in 2006 was amended by the Securities Markets Amendment Act 2006 to a market fairness regime henceforth referred to as the Securities Markets Act 1988 ("SMA") in order to distinguish between the different prohibitions sharing the same statute. The prohibition currently found in the FMCA is largely identical to the amended regime that existed under the SMA.[22]

There are two key aspects to the regulation of corporate information in Part 5 of the FMCA. First, subpart 2 prohibits insider conduct on licensed markets (in New Zealand's case, the NZX[23]). Secondly, subpart 4 ensures listed issuers adhere to the NZX continuous disclosure rules to ensure "material information" is made immediately available to the market, thereby limiting the window in which insider conduct may occur. While the insider trading prohibition and the continuous disclosure rules are interdependent, this dissertation will confine its analysis to the insider trading prohibition.

The insider trading prohibition is set out at s 240 of the FMCA, which provides that a person who is an information insider of a listed issuer or in relation to quoted derivatives must not trade financial products of the listed issuer or the relevant derivatives; disclose inside information to another person; or advise or encourage insider trading. Contravention of the

[21] Victoria Stace *Securities Law in New Zealand* (LexisNexis, Wellington, 2010) at 485. Note that "financial markets" is defined broadly in the Financial Markets Authority Act, at s 4, so as to apply to the provision of financial services as well as capital markets.
[22] The only change between the SMA (see table of abbreviations) and the FMCA insider trading regimes is that the FMCA explicitly extends the prohibition to derivatives. Compare Securities Markets Act 1988 (No 234), ss 8C-8E and Financial Markets Conduct Act 2013, ss 241-243.
[23] Mortlock, above n 10, at 47.

prohibition can give rise to civil or criminal liability, with a heightened knowledge requirement for criminal liability. I will now explore each element of the prohibition.

What is information?

What constitutes "information" for the purposes of the prohibition is not meaningfully defined in the FMCA; s 6 simply sets out that information "includes documents". As the FMCA is relatively untested in the courts, the interpretation of "information" under the SAA and in Australia will be highly influential. In relation to the SAA, the Securities Commission refused to suggest that "information" had to be specific, and endorsed the notion that inferences will be sufficient as long as they possess greater specificity than "a hunch or shrewd or educated guess".[24]

Against this backdrop, the Court of Appeal in *Haylock v Patek* held that a broad interpretation of "information" was justifiable under the SAA, so that certain matters of opinion, as well as matters of fact, will count as information.[25] The Court qualified its broad interpretation with the observation that a floor must be set so that every piece of "tittle tattle" would not engage the prohibition;[26] it interpreted "information" in its statutory context by holding that the statute made clear that information (regardless of specificity) must be material in order to be "inside information".[27] Therefore, unsubstantiated rumours are unlikely to be "information", but matters of opinion given by senior company executives may be sufficiently influential to satisfy the materiality requirement. The Court's decision in *Haylock* is the leading exposition of what constitutes "information" under the SAA; in my view, its import applies readily to the FMCA.

"Information insider"

The class of persons who may engage in insider trading are labelled "information insiders" in the FMCA. Section 234 defines this class widely: any person in possession of "material information" that is not "generally available" to the market is captured, irrespective of any connection to the listed issuer.

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[24] Securities Commission *Report of an Inquiry into Aspects of the Affairs of Regal Salmon Ltd Including Trading in its Listed Securities* (1994) at 19.84.
[25] *Haylock v Patek* [2011] NZCA 674 at [123].
[26] At [124].
[27] At [125]; see also: SAA, s 2 – "inside information" and compare: FMCA, s 234(4).

The broad capture of s 234 juxtaposes against the narrow definition of "insider" under New Zealand's former insider trading regime contained in the SAA.[28] Under the SAA, the class of "insider" was limited to:[29]

(a) the issuer itself;

(b) those who, by reason of their being a principal officer, employee, company secretary, or substantial security holder of the issuer had inside information about the issuer or another public issuer;

(c) those who received inside information in confidence from a person described in paragraph (a) or (b);

(d) those who, by reason of their being a principal officer, employee, company secretary, or substantial security holder of a person described in (c) had that inside information;

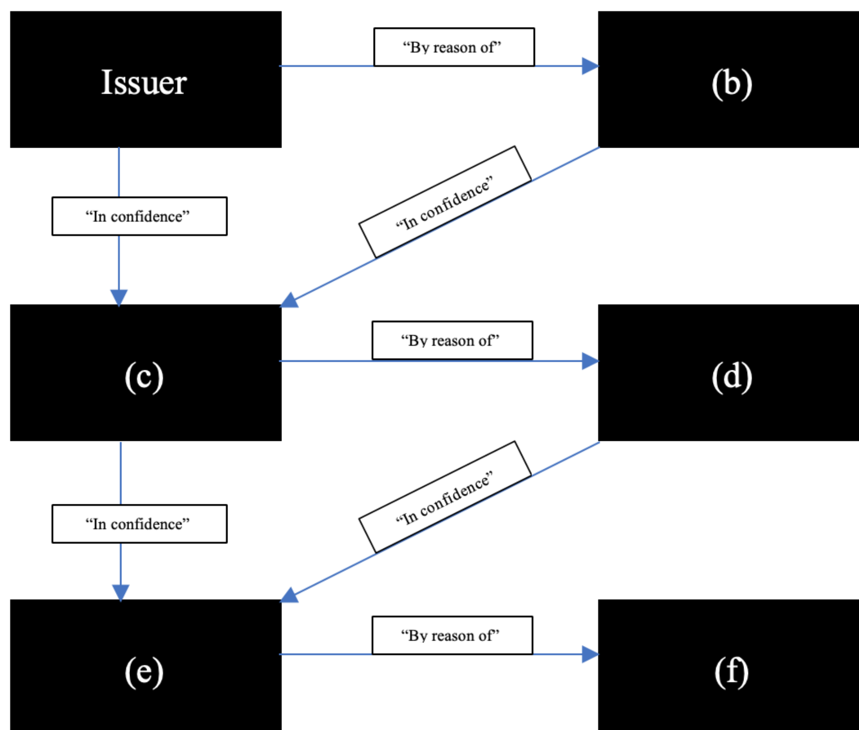
(e) those who received inside information in confidence from a person described in (c) or (d); and

(f) those who, by reason of their being a principal officer, employee, company secretary, or substantial security holder of a person described in (e) had that inside information.

To illustrate the potential information flow between insiders under the SAA regime, a diagram may be of assistance:

[28] SAA, s 3.

[29] Section 3.



The class of persons potentially liable under the FMCA regime is practically unbounded compared with under the SAA. This reflects the market fairness rationale: under the FMCA it is inconsequential how the impugned trader obtained the inside information; simply, the information should have been available to the entire market. The mere act of trading while in possession of that information hurts the market.[30]

In *Haylock v Patek*,[31] shortcomings of the narrow definition of "insider" in the SAA were exposed. Southern Petroleum NL ("SPNL") was a listed oil and gas company. Approximately 85 per cent of the shares in SPNL were owned by Petrocorp Exploration Ltd ("Petrocorp"), a wholly-owned subsidiary of the Fletcher Challenge Group ("Fletchers"). Therefore, Petrocorp was a substantial security holder of SPNL.[32] Fletchers made a takeover offer for the remaining minority shareholding through a subsidiary incorporated especially for the purpose, Petroleum Industries Ltd ("PIL"). The minority shareholders strongly opposed the takeover, and following its completion brought insider trading proceedings against James Patek, the chief executive of Petrocorp and Fletcher Challenge Petroleum (a Fletchers company to which

[30] Rather than the issuer or counterparty to the trade, as was the case under the SAA.
[31] *Haylock v Patek* [2009] 1 NZLR 351 (HC).
[32] SAA, ss 2 and 5.

Petrocorp reported).[33] The minority shareholders alleged PIL launched the takeover while in possession of inside information concerning gas exploration prospects in Mangahewa that was not disclosed. However, Williams J in the High Court held that Patek and Petrocorp obtained the viability report under a joint venture agreement with SPNL, rather than "by reason of" Petrocorp's substantial security holding, nor in confidence from an insider; the requisite nexus was not present.[34] Additionally, Patek was not an insider as it was not established that he "had" the inside information at all relevant times.[35] The finding that Petrocorp was not an insider of SPNL represents an instance in which the broad capture of the market fairness regime would have generated a different outcome: if the information was shown to be material and non-public then any dealing by Petrocorp while in possession of that information would attract liability.[36] No question as to the source of the information would arise.

Material information

Section 231(1) of the FMCA defines "material information" in relation to a listed issuer as information that:

a) a reasonable person would expect, if it were generally available to the market, to have a material effect on the price of quoted financial products of the listed issuer; and
b) relates to particular financial products, a particular listed issuer, or particular listed issuers, rather than to financial products generally or listed issuers generally.[37]

The above definition is extended to derivatives with the necessary qualifications by s 231(2).

The current definition of materiality is slightly different in focus from its predecessor under the SAA.[38] Under the SAA, material information was that which "would, or would be likely to, affect materially the price of the securities of the public issuer if it was publicly available". Juxtaposing these past and present definitions, it seems s 231 inserts the "reasonable person" touchstone to require an objective assessment of materiality.[39] This is consistent with the broad capture of the market fairness regime, as the class of potential information insiders is boundless

[33] Shell Exploration NZ Ltd was added as a second defendant when it acquired Fletcher Challenge's energy interests in October 2000. See *Haylock* [2009] at [22].
[34] At [255].
[35] At [317] and [326].
[36] Assuming the trader knew, or ought to have known, of the information's materiality. See: FMCA, s 234.
[37] The same definition is employed in the NZX Listing Rules at r 1.6.1.
[38] SAA, s 2.
[39] Harrison J found this to be the effect of reference to the "reasonable person" in relation to the continuous disclosure regime, in *Auckland International Airport v Air New Zealand Ltd* (2006) 9 NZCLC 264,179 at [57].

(compared to the narrow class of "insider" under the SAA, to which some commercial acumen could be ascribed, obviating the need for recourse to reasonableness). Roger Partridge has argued there is "no room" for the reasonable standard in s 231, as information is either price sensitive, or it is not.[40] His argument hinges on the assumption that materiality can be determined by expert evidence as a matter of fact. In my view, Partridge overlooks the complexities in determining materiality through expert evidence.

The expert evidence offered in *Haylock* demonstrates this complexity. Williams J in the High Court was presented with "several hundred pages of technical and expert evidence" directed towards answering whether the viability report would, or would have been likely to, have affected SPNL's share price.[41] The expert evidence was long, complex and mired in disagreement. The mere fact of expert disagreement appears to demonstrate the inherent difficulty in determining materiality as fact. The introduction of the "reasonable person" test in s 231 of the FMCA seems to release courts from this task, allowing recourse to the expectations of a hypothetical person to resolve the issue of price-sensitivity. This may have the positive effect of abbreviating trials in which materiality is at issue.

Furthermore, the Court in *Haylock* was required to quantify a material price movement. Williams J relied on expert evidence in deciding that a price movement exceeding 15 per cent would be material for SPNL.[42] While this was ultimately inconsequential to the decision, it demonstrates a further issue with the lack of an objectivity requirement in the SAA: conceivably, a broad range of price movements could be convincingly justified as "material" on a number of bases; tasking the courts with choosing an exact threshold fails to take into account other forces influencing the market price and in my opinion takes an artificial view of market movements. Certainly, behavioural finance would suggest that some market movements are caused by "noise traders" in possession of incomplete or inaccurate information.[43] While economic evidence is an important touchstone for the judiciary that prevents evaluations being made on the basis of "untested intuitions",[44] I contend that the voluminous evidence required to assess materiality impedes judicial decisionmaking, and the

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[40] Roger Partridge "Insider trading reform" [2006] NZLJ 311 at 311.
[41] *Haylock* (2009) at [330]
[42] *Haylock* (2009) at [465]-[466].
[43] See: Brett Trueman "A Theory of Noise Trading in Securities Markets" 43 J Finance 83.
[44] Shelley Griffiths "A Short History of Law and Economics in New Zealand in the 1990s" in Shelley Griffiths, Mark Henaghan and M B Rodriguez Ferrere (eds) *The Search for Certainty: Essays in Honour of John Smillie* (Thomson Reuters, Wellington, 2016) 151 at 163.

exercise of quantifying materiality itself is something of a contrivance. Accordingly, I consider the introduction of the "reasonable person" standard in the FMCA ameliorates the evidential difficulties faced by the courts in *Haylock*.

While importing a reasonableness standard, s 231 is silent as to whom the "reasonable person" may be. Therefore, the courts will be tasked with characterising this legal fiction should the matter come before them. Section 231's silence sits in contrast to the Australian Corporations Act 2001 (Cth), which deems that a "reasonable person" is one who would expect information to be material if "the information would, or would be likely to, influence persons who commonly acquire Division 3 financial products in deciding whether or not to acquire or dispose of the first-mentioned financial products".[45] In my view, this partially imports the "reasonable investor" test found in the US jurisprudence, as against the "market impact" approach adopted by New Zealand courts under the SAA.[46] I suggest *infra* that a complete move to a reasonable investor standard would be more efficacious.

A deeming provision resembling s 1042D of the Australian Corporations Act was included in the Securities Market Amendment Bill,[47] but was removed in response to submissions that such a provision would take the focus away from the price sensitivity of the information and conflict with the rationale behind an insider trading prohibition.[48] At a policy level, insider trading regulation is directed towards preventing traders exploiting an unfair informational advantage for profit, and I agree with Partridge that in the abstract, a deeming provision lacks any purpose if it deems information to be material when that information never possessed any price sensitivity. However, as I demonstrate above, price sensitivity of information, as a matter of fact, cannot be easily determined. Therefore, I argue a deeming provision would create greater certainty when it comes time for courts to interpret s 231 by guiding judges towards a broader and more qualitative "reasonable investor" approach,[49] preventing to some extent the difficulties faced in *Haylock*. The benefit of greater clarity outweighs the cost of taking the focus away from price sensitivity of information.

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[45] Corporations Act 2001 (Cth), s 1042D.
[46] Note that s 1042D modifies the *TSC* Test somewhat by focusing on the reasonable investor's trading, rather than their voting.
[47] Securities Market Amendment Bill 2006 (234-3B).
[48] Partridge, above n 40, at 311.
[49] IOSCO has written that a reasonable investor test "expands the possibilities of material that may be classed as material". Emerging Markets Committee of the International Organisation of Securities Commissions *Insider Trading: How Jurisdictions Regulate It* (2003) at 4.

The "reasonable investor" test determines materiality by considering the significance a hypothetical reasonable investor would attribute to the information in question. This has been the dominant approach in the United States jurisprudence since the Supreme Court decided *TSC Industries v Northway* in 1976.[50] The test articulated by the Court ("the *TSC* Test") was that non-public information will be material in relation to a private company "if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote".[51] The *TSC* Test does not require an actual effect on the shareholder's voting decision; rather, it is sufficient for the information to assume "actual significance" in the shareholder's deliberations.[52] The Supreme Court in *Basic, Inc v Levinson* endorsed the *TSC* Test in relation to the secondary market.[53] In New Zealand, Cooke J (as he then was) commented he was "well content" to adopt the *TSC* Test in its entirety in *Coleman v Myers*.[54] *Coleman* concerned a closely held private company, and a fiduciary duty was imposed due to the unique family circumstances of the impugned transaction.[55] Section 1042D of the Australian Corporations Act can be seen as adopting this common law approach into statute, albeit with a focus on the acquisition or disposal of securities, rather than a shareholder's choice how to vote. I suggest this qualitative determination is less onerous for the courts than the quantitative assessment required under the SAA.

The market impact approach gauges materiality by the information's potential effect on the market price of the security it concerns.[56] Adoption of this approach implicitly endorses the semi-strong form of the efficient capital markets hypothesis ("EMH"), which hypothesizes that the price of a quoted financial product promptly and accurately impounds all publicly available information.[57] While the EMH has been a subject of debate, it remains the orthodox regulatory theory.[58] The inherent difficulty with the market impact approach lies in determining what

[50] *TSC Industries v Northway Inc* (1976) 426 US 438.
[51] *TSC Industries* at 2132.
[52] *TSC Industries* at 2132.
[53] *Basic, Inc v Levinson* 485 US 438 (1988) at 232.
[54] *Coleman v Myers* [1977] 2 NZLR 225 at 334.
[55] At 351.
[56] Peter Fitzsimons "Insider Trading in New Zealand" in Gordon Walker, Brent Fisse, and Ian Ramsay (eds), *Securities Regulation in Australia and New Zealand* (2nd ed, LBC, Sydney 1998) 595 at 606.
[57] See: Jonathan Law *A Dictionary of Banking and Finance* (6th ed, Oxford University Press, Oxford, 2018).
[58] Dana M Muir and Cindy A Schipani "The use of Efficient Market Hypothesis: Beyond SOX" (2007) 105 Mich L Rev 1941 at 1943.

effect will be significant enough to render the information material, as the court had to decide in *Haylock*.

Despite Cooke J's content in adopting the reasonable investor approach of the *TSC* Test in *Coleman*, this approach was disposed of by New Zealand courts following the SAA's explicit adoption of a market impact test in the statute.[59] No mention was made of the *TSC* Test by the High Court when the decisions of *Wilson Neill* and *Kincaid (No 2)*, both concerning the SAA, were handed down.[60] In the SAA, a market impact test adopted at s 2 was consistent with the narrow definition of "insider", as "inside information" could only be obtained by reason of a trader's personal connection to a company, thus, it could be assumed that information obtained through such an otherwise inaccessible avenue inherently possessed at least some significance to the reasonable investor. The introduction of the objectivity requirement in s 231 of the FMCA requires a fresh appraisal of the soundness of a market impact approach.

In my view, adding a deeming provision in relation to the "reasonable person" test in s 231 of the FMCA along the lines of s 1042D of the Australian Corporations Act would allow the explicit adoption of a reasonable investor test, which is a sounder approach in several respects as against the current test in the FMCA. First, courts are better equipped to employ the qualitative reasonable investor test; adopting it would obviate the need for the artificial exercise of quantifying materiality (undertaken in *Haylock*). Secondly, a deeming provision would clarify the appropriate approach to be taken to s 231, as at present, the "reasonable" expectation that information would affect the market price conflates the market impact and reasonable investor approaches. Thirdly, the reasonable investor approach is conceptually more robust, as it is not predicated on an acceptance of the EMH. Finally, a reasonable investor approach aligns with the US jurisprudence, which can be seen as the most developed body of securities law internationally.[61] Therefore, greater clarity concerning s 231 of the FMCA would be obtained by explicitly adopting a reasonable investor test through a deeming provision.

[59] SAA, s 2 – "inside information".
[60] *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 (CA) and *Re Bank of New Zealand; Kincaid v Capital Markets Equities Ltd (No 2)* (1995) 7 NZCLC 260,718. See: Fitzsimons, above n 57, at 610.
[61] Alexander F Loke "From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the UK, Australia and Singapore" (2006) 54 Am J Comp Law 123 at 124.

"Generally available to the market"

If material information is generally available to the market, it will not engage the prohibition. The concept of general availability to the market is defined by s 232(1) of the FMCA, which specifies that information is "generally available to the market":

> (a) if—
>
> > (i) it is information that has been known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in relevant financial products; and
> >
> > (ii) since it was made known, a reasonable period for it to be disseminated among those persons has expired; or
>
> (b) if it is likely that persons who commonly invest in relevant financial products can readily obtain the information (whether by observation, use of expertise, purchase from other persons, or any other means); or
>
> (c) it is information that consists of deductions, conclusions, or inferences made or drawn from either of the kinds of information referred to in paragraphs (a) and (b).

This definition provides greater certainty than its equivalent under the SAA, which merely referred to information "which is not publicly available".[62] In my view, the current definition reduces ambiguity as to availability. Given NZX's continuous disclosure requirements, dissemination of material information through the Market Access Platform ("MAP") is an example of a manner in which disclosure would satisfy s 232(1)(a) and (b).[63]

Furthermore, s 232(1)(b)'s use of "readily obtain" improves the equivalent Australian provision on which it was modelled, which deems information generally available if "it consists of readily observable matter".[64] Difficulties with this definition arose in *R v Kruse* and *R v Firns*.[65] Both concerned trading in Carpenter Pacific Resources NL ("Carpenter"), a firm with mining interests in Papua New Guinea. Carpenter had been embroiled in litigation, and a verdict was given in its favour on 28 July 1995. Mr Kruse was present at the court and called his broker later that day to place an order for 800,000 shares in Carpenter. Mr Kruse sold those

[62] SAA, s 6.

[63] Assuming a "reasonable period for it to be disseminated" per s 232(1)(a)(ii) has passed.

[64] Corporations Act 2001 (Cth), s 1042C.

[65] *R v Firns* (2001) 51 NSWLR 548; *Kruse v Commonwealth Director of Public Prosecutions* [2001] NSWCA 59.

shares four days later for a profit of $50,000. Contemporaneously in Australia Ronald Firns, a director of Carpenter, received a phone call relaying the news of the favourable judgment. He asked his son Kenneth to buy shares in Carpenter;[66] Kenneth bought 400,000 shares in his wife's maiden name.[67] News of the verdict was not released to the Australian market until three days after these trades occurred. Both Kruse and Firns were charged with insider trading, and at issue in each case was whether they traded on information that was not "generally available". In the District Court, Kruse was acquitted on the basis that the delivery of the judgment was a "readily observable matter". However, Firns was convicted, on the basis that the information being obtainable by phone call did not make it generally available. Firns appealed, and the New South Wales Court of Appeal allowed the appeal, holding information outside Australia could also be readily observable. The use of "readily obtain" in s 232(1)(b) of the FMCA is clearly employed to prevent similar issues arising in New Zealand.

The notion of 'ready obtainability' under the FMCA connotes a narrower capture than 'ready observability' under the Australian Corporations Act, with the likely effect that the information in *Kruse* and *Firns* would not be deemed readily obtainable under the FMCA, and convictions for insider trading would likely result: despite the verdict being publicly available, it does not seem to have been disseminated in a manner that would have brought it "to the attention of persons who commonly invest in relevant financial products", nor was it readily obtainable "without difficulty" by that class of person either.[68] Therefore, the construction of s 232 appears to remedy the difficulties that have arisen in Australia. However, this frustrates the purpose of trans-Tasman harmonisation to some extent.[69]

Despite the wording of s 232(1)(b) of the FMCA having improved upon its equivalent in the Australian Corporations Act, the requirement that a "reasonable period" of time expire before information is deemed generally available creates theoretical inconsistency within s 232.[70] As Partridge notes, information that is made available in accordance with s 232(1)(a)(i) necessarily falls within s 232(1)(b):[71] if information is known in a manner that would be likely to bring it to the attention of investors, it will be readily obtainable by the same investors. However, the

[66] Gregory Lyon and J J Du Plessis *The Law of Insider Trading in Australia* (Federation Press, Sydney, 2005) at 37.
[67] Partridge, above n 40, at 312.
[68] Partridge, above n 40, at 312.
[69] (14 December 2004) 622 NZPD 18041.
[70] FMCA, s 232(1)(a)(ii).
[71] Partridge, above n 40, at 312.

"reasonable period" requirement only applies to s 232(1)(a). Therefore, the time requirement is superfluous. Additionally, the requirement seems somewhat redundant in the internet age, as information can be disseminated almost instantaneously compared to the disclosure methods of the past, such as newspapers.

The Securities Commission sought to resolve s 232's internal inconsistency by distinguishing between the types of information captured by each limb of the section. It wrote that s 232(1)(a) targets "published information", such as information released to the market through MAP, and that, conversely, s 232(1)(b) targets "readily available information", which can be "obtained without difficulty".[72] No examples of readily available information are given, and the distinction between these types of information does not seem to resolve s 232's internal inconsistency.[73] In the absence of specific examples, information that can be readily obtained without requiring publication, such as the effect of a drought on agricultural firms, would presumably fall under s 232(1)(b).

The Australian definition of "generally available" and the difficulties manifest in *Kruse* and *Firns* have, in my view, led to a more effective definition in s 232 of the FMCA. However, s 232(1)(a)(ii) appears redundant in light of s 232(1)(b)'s construction. The "reasonable period" requirement found in the Australian Corporations Act preceded the advent of the commercial internet,[74] and its inclusion in the FMCA may not reflect modern practical realities.[75]

Knowledge

As discussed above, a person is an "information insider" captured by the insider trading prohibition if that person has material information relating to the listed issuer that is not generally available to the market, and that person knows or ought reasonably to know that the information is material and not generally available to the market.[76] Actual or constructive knowledge of materiality and non-availability is a new requirement under the market fairness

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[72] 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) at 37.
[73] Stace, above n 21, at 294, n 42.
[74] Noting that the insider trading provisions in the Corporations Act 2001 (Cth) have been substantially carried forward from the Corporations Law 1990 (Cth), as amended by the Corporations Legislation Amendment Act 1991 (Cth) (see Appendix I). John Naughton "The evolution of the Internet: from military experiment to General Purpose Technology" (2016) 1 Journal of Cyber Policy 5 at 12.
[75] Or, an undue focus on harmonisation of the Australian and New Zealand regimes. See: Partridge, above n 40, at 312.
[76] FMCA, s 234.

regime to prevent s 234 capturing trading by 'accidental' insiders. This is conceptually consistent with the imposition of a market fairness regime, however, the knowledge requirements are untested by the courts, and the risk now exists that "difficulties of proof" may thwart the prohibition. In particular, proving subjective or constructive knowledge may prove especially difficult in criminal cases, when it must be established beyond reasonable doubt.

Under the SAA, a knowledge requirement would have risked unduly limiting the prohibition's effect, given the narrow class of persons deemed "insiders" could be expected to understand materiality and availability of information by reason of their personal connection to listed issuers, which imputed to them some degree of commercial acumen. The same cannot be expected of the public at large under a market fairness regime. As the Court of Appeal held in *Wilson Neill*:[77]

> We do not accept the argument presented for Magnum by Mr Latimour that the nominee directors did not 'possess' the information because they had not done, or were not proved to have done, an analysis of material in the compendious board papers furnished to them from which the information could be inferred. The test is not subjective knowledge but the objective possession of information. Otherwise, the purpose of the legislation could be thwarted by difficulties of proof.

Under the FMCA, the nominee directors in *Wilson Neill* would only be liable if actual or constructive knowledge of materiality and non-availability of the information could be established.[78]

The offence provisions

The insider trading prohibition engages once a person is deemed an "information insider".[79] In relation to the listed issuer (or derivatives) in respect of which the person is an information insider, the information insider must not:

- trade (meaning acquire or dispose except by inheritance or gift) quoted financial products of the listed issuer;[80] or, if the trader is an information insider in relation to

[77] *Wilson Neill*, above n 60, at 13.
[78] Stace, above n 21, at 287.
[79] FMCA, s 240.
[80] Section 241(1).

quoted derivatives, trade those derivatives.[81] Henceforth, I will refer to this behaviour as "trading".

- directly or indirectly disclose inside information to another person, if the insider knows or ought reasonably to know or believes that that person will, or is likely to—
    - trade quoted financial products of the listed issuer[82] or quoted derivatives[83]; or
    - advise or encourage a third person to trade or hold those financial products[84] or derivatives.[85] I will refer to this behaviour as "tipping".
- advise or encourage[86] another person to trade or hold quoted financial products of the listed issuer[87] or quoted derivates[88], or advise or encourage that person to advise or encourage a third person to trade or hold those financial products[89] or derivatives.[90] I will refer to this behaviour as "advising".

Notably, under s 234 of the FMCA, trading as an information insider is all that is necessary to attract liability; there is no requirement for a causal link between the possession of inside information and the incriminating trade. This is a manifestation of the market fairness rationale.[91]

The offence provisions of the FMCA are substantially similar to their predecessors under the SAA. However, the imposition of criminal liability was a key change implemented by the Securities Markets Amendment Act 2006 that has continued under the FMCA.[92]

Exceptions and defences

Within the FMCA, a number of exceptions have been carved out from the prohibition on insider trading.[93] If an exception is made out, the prohibition will not apply, and an information insider will not be liable for any breach of the offence provisions. The exceptions ensure the

[81] Sections 234(3) and 241(2).
[82] Section 242(1)(a).
[83] Section 242(2)(a).
[84] Section 242(1)(b).
[85] Section 242(2)(b).
[86] Section 6 defines "encourage" for the purposes of pt 5, sub-pt 2 to include "incite, counsel or procure".
[87] Section 243(1)(a).
[88] Section 243(2)(a).
[89] Section 243(1)(b).
[90] Section 243(2)(b).
[91] *R v Sansom* [2018] NZHC 542 at [24].
[92] See Appendix I.
[93] Sections 245-246.

prohibition does not conflict with the operation of other provisions in the FMCA or impede the efficiency of the law or the capital markets. The statutory exceptions are set out in full at Appendix II in the interests of completeness, but are tangential to this dissertation.

The FMCA also sets out affirmative defences to insider conduct.[94] These defences cover situations in which context ameliorates the information asymmetry that renders insider conduct undesirable market behaviour. For example, if inside information is obtained by independent research and analysis, a defence will exist as the informational advantage has been obtained legitimately.[95] Similarly, the defences are set out in full at Appendix II.

Enforcement of the prohibition

Insider trading presents unique challenges to enforcement, and an analysis of the detection and enforcement of it will complete my analysis of the current regime. Unlike criminal offences, insider trading offences under the FMCA are outside the jurisdiction of the Police and are, instead, dealt with by the FMA. Insider trading is commonly seen as a victimless crime, precluding enforcement by wronged parties under the law of tort. The idea of insider trading as a victimless crime was given voice by Karen Chang, head of enforcement at the FMA, when commenting on a 2019 FMA insider trading settlement:[96]

> It's a gesture with a punitive element rather than a compensatory one because of course there are no victims, so there is no one to compensate. … The scale of the transaction in terms of profits or losses is really irrelevant when you look at the harm that this kind of behaviour causes in eroding investor confidence and eating away at the integrity of our market, which we guard pretty jealously.

As Chang's quote evinces, insider trading is not seen as a crime against public order or private rights. Rather, it is offending that harms the "integrity of our market", a somewhat abstract notion compared to other more common offences. This conception of insider trading raises some interesting conceptual issues concerning enforcement and punishment that I will examine in Chapter 3.

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[94] Sections 257-261.
[95] Section 258.
[96] Jamie Gray "Former executive Mark Talbot to pay $150,000 for insider trading" *The New Zealand Herald* (online ed, New Zealand, 9 April 2019).

Before a victim can be identified, corporeal or otherwise, insider trading must first be detected. In the New Zealand context, both NZX and the FMA play important roles in identifying insider trading and enforcing the prohibition. "Front line" responsibility for detecting insider trading rests with NZX as a self-regulating market operator,[97] however, the FMA retains complete regulatory oversight.[98] NZX and the FMA are parties to a Memorandum of Understanding that guides the two organisations in their respective roles by facilitating co-operation and ensuring enforcement efforts do not unnecessarily overlap.[99]

NZX's role in the detection of insider trading

The NZX Regulation team is a standalone division of NZX with three broad regulatory focuses: issuer compliance, participant compliance and surveillance.[100] Responsibility for detecting insider trading lies with the NZX Surveillance division of the Regulation team, which monitors trading activity on the NZX. NZX Surveillance is the 'first line of defence' against insider trading given its detection and preliminary investigative functions.

NZX Surveillance detection efforts include the use of SMARTS, a market surveillance software employed to flag abnormal trading and profits that may suggest instances of insider trading. SMARTS is utilised by seventeen regulators on forty-five exchanges worldwide, including NASDAQ.[101] Relevantly, the software is also used by the ASX in its enforcement efforts in the Australian market.[102]

If the Surveillance division deems suspicious market conduct worthy of further investigation, it will refer the matter to the Participant Compliance division.[103] NZX is empowered under the FMCA to refer information to the FMA when it considers necessary,[104] and is required under the FMCA to notify the FMA of suspected contraventions of the Act.[105] NZX confirmed in its

[97] *Financial Markets Authority v Warminger* [2017] NZHC 327 at [9].
[98] NZX "NZX Regulatory Model" <www.nzx.com>.
[99] NZX "Ensuring quality regulation of NZX market operations" <www.nzx.com>.
[100] NZX "How does NZX regulate its markets?" <www.nzx.com>.
[101] Anna Irrera "NASDAQ to acquire UK market surveillance startup" *Reuters* (online ed, New York, 25 July 2017).
[102] Australian Securities and Investments Commission "ASIC acquires integrated market surveillance system" (media release, 24 March 2010).
[103] NZX "How does NZX regulate its markets?", above n 100.
[104] FMCA, s 358.
[105] FMCA, s 352.

Approach to Enforcement document that given its seriousness, suspected insider trading will likely be referred directly to the FMA when detected, rather than dealt with internally.[106]

Despite the inherent difficulty in detecting insider trading,[107] in 2015 NZX Surveillance detected suspicious trading by Jeffrey Honey in ERoad shares in advance of an adverse market announcement.[108] Honey had early access to the non-public information in his role as Insights and Analytics Manager at ERoad.[109] Honey pleaded guilty to the criminal charges of insider trading brought by the FMA,[110] becoming the first person to be prosecuted for insider trading in New Zealand. NZX Surveillance also detected insider trading in VMob by its CFO, Mark Talbot in September 2014. Talbot admitted breaching the SMA prohibition and gave an enforceable undertaking to the FMA.[111] These two cases demonstrate that NZX Surveillance does detect some insider trading notwithstanding the inherent difficulty in doing so.

NZX Surveillance's detection role is bolstered by the NZX Market Participant Rules,[112] which require brokers to refer suspected insider trading by clients to their Compliance Manager,[113] who will, in turn, inform NZX.[114]

The FMA's role in the detection of insider trading

While the NZX will likely refer suspicious trading to the FMA, suspected insider trading can also be reported directly to the FMA by any other person. Additionally, the FMA possesses a wide range of information gathering and enforcement powers.[115] These include the power to require any person (by written notice) to supply information[116] and to "enter and search a place, vehicle or other thing" (by consent or warrant) to ascertain whether a breach of the financial market legislation has occurred.[117]

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[106] NZX "Approach to Enforcement" (March 2019) <www.nzx.com> at 6.
[107] Tony D'Aloisio, Chairman of the Australian Securities and Investments Commission, "Insider trading and market manipulation" (Supreme Court of Victoria Law Conference, Melbourne, 13 August 2010) at 12.
[108] *Honey*, above n 1, at [19].
[109] *Honey* at [4].
[110] Financial Markets Authority "ERoad – Hamish Sansom and Jeffrey Peter Honey" (updated 30 September 2018) <www.fma.govt.nz>.
[111] Financial Markets Authority "Former CFO to pay $150,000, barred for Securities Markets Act breaches" (media release, updated 9 April 2019) <www.fma.govt.nz>.
[112] NZX "Market Participant Rules" (1 July 2019) <www.nzx.com>.
[113] Participants are required to have a Compliance Manager by r 3.11 of the Market Participant Rules.
[114] NZX Market Participant Rules, rule 15.6.
[115] Financial Markets Authority Act, pt 3.
[116] Financial Markets Authority Act, s 25.
[117] Financial Markets Authority Act, s 29.

The enforcement framework

The FMA has a wide range of regulatory responses available to deal with insider trading once detected. The responses range from low-level, informal intervention to criminal prosecution.[118] The FMA is empowered to choose a response that is appropriate given its statutory objective.[119] Considering insider trading enforcement is a strategic priority for the FMA,[120] low-level intervention seems an unlikely prospect if suspicions of insider trading are well-founded. Accordingly, the FMA appears likely to pursue insiders under the civil or criminal liability regimes. The FMA chose the criminal enforcement regime in *Honey* and *Sansom*, however, the civil standard of proof may appear attractive for future cases following Sansom's acquittal.

Under the FMCA's civil liability regime,[121] the FMA or any person may apply to the High Court for a declaration of contravention. If a declaration is obtained, only the FMA may seek a pecuniary penalty order as a public enforcement remedy.[122]

The maximum pecuniary penalty that the High Court can order (on an application by the FMA) is the greatest of the consideration for the transaction that constituted the contravention, $1 million, or three times the gain made or loss avoided by the transaction.[123] The FMCA provides guidance to the High Court on how to determine the quantum of a penalty, including that any gain made or loss avoided by insider trading is to be calculated as the difference between the consideration paid or received in the transaction and the value the financial product would have had at the time of the issue or sale if the material information had been generally available to the market.[124] While this guideline presents similar issues to those I have outlined *supra* concerning the definition of materiality,[125] I do not see s 491 presenting the same evidential and theoretical difficulties given the calculation can be made with a purely retrospective gaze.

[118] Financial Markets Authority "Regulatory Response Guidelines" (August 2016) at [30].
[119] Financial Markets Authority Act, s 7.
[120] Financial Markets Authority "Annual Corporate Plan 2019/20" (April 2019) at 8-11.
[121] FMCA, pt 8 sup-pt 3. Part 5 imposes civil liability for insider trading and accordingly is subject to the civil liability regime (alongside the criminal liability provision at s 244).
[122] FMCA, s 489. Note that any person that believes they have suffered, or are likely to suffer, loss or damage due to insider trading may seek a compensatory order under s 494 of the FMCA. However, given the requirement that the applicant demonstrate loss or damage, it seems compensatory orders are better suited for other civil liability provisions (such as defective disclosure in a PDS under the FMCA, pt 3) due to the common conception of insider trading as a victimless crime.
[123] FMCA, s 490.
[124] FMCA, s 491
[125] FMCA, s 231.

In my view, this retrospective calculation is permissible as the liability provisions do not serve as a guide to conduct, while the definition of materiality does.

In addition, the FMA can also settle matters by way of a conventional settlement or by accepting an enforceable undertaking[126] from an inside trader either prior to, or following commencement of High Court proceedings.[127] The FMA will consider all reasonable settlement proposals that meet its regulatory objectives under its Model Litigant Policy.[128]

The FMA's ability to settle insider trading cases has been criticised for its potential subversion of the court process. Following Mark Talbot's enforceable undertaking with the FMA in 2019,[129] business journalist Karyn Scherer questioned the FMA's approach to enforcement:[130]

> Why do we believe we are punishing well-off people when we let them write a cheque? And how do we think it will deter others from similarly bad behaviour? … It doesn't seem unreasonable to ask after all this time whether the right message is being sent.

Undoubtedly, the FMA does not have infinite resources with which to pursue insider trading cases. A balance must be struck, especially considering the FMA reportedly expended over 2,500 internal staff hours and $89,000 in prosecuting *Honey* and *Sansom*.[131]

Chapter 2: Why regulate insider trading?

Having addressed the current law and some theoretical issues it presents, I will now explore the deeper conceptual underpinnings of insider trading regulation.

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[126] Financial Markets Authority Act, s 46.
[127] Chris Curran, Marika Eastwick-Field and Nathaniel Walker "New Zealand" in William Savitt (ed) *The Securities Litigation Review* (5th ed, Law Business Research, London, 2019) at 188.
[128] Financial Markets Authority "Model Litigant Policy" (28 June 2013).
[129] Financial Markets Authority "Former CFO to pay $150,000, barred for Securities Markets Act breaches", above n 111.
[130] Karyn Scherer "Taking the money and running" *The National Business Review* (online ed, New Zealand, 15 April 2019).
[131] The National Business Review reported the costs as 2,538 staff hours and $89,093 per an Official Information Act request made in April 2018. Sansom was acquitted in September 2018. See: Dane Ambler "Crown fails to secure guilty verdict in first insider trading trial" *The National Business Review* (online ed, New Zealand, 21 September 2018).

The current orthodox view is that insider trading regulation is necessary for secondary markets to be fair and efficient; this view is reflected in the International Organisation of Securities Commission's ("IOSCO") Objectives and Principles of Securities Regulation.[132] IOSCO's membership comprises 129 primary securities regulators representing more than 90 per cent of international securities markets, including the NZX;[133] membership is predicated on a commitment to upholding IOSCO's objectives and principles.[134] Accordingly, it is difficult to conceive an IOSCO member jurisdiction deregulating insider trading in the foreseeable future. However, the arguments against insider trading regulation are worth consideration; they retain an important place in the academic discourse, and an analysis of these arguments will provide a foundation for my subsequent analysis regarding the necessity of an insider trading prohibition in New Zealand.

The arguments against prohibition of insider trading proceed on two main bases: moral and economic. It is worth setting out the key moral and economic arguments against prohibition, as they inform the market fairness rationale currently employed in the New Zealand regime.

Moral arguments

The moral arguments against insider trading prohibition orbit around often "ill-defined" notions of fairness and market egalitarianism,[135] and the question as to whether insider trading is truly a victimless crime. One's position on the morality (or lack thereof) of insider trading inevitably involves some value judgment, and accordingly, this aspect of the debate defies a rigorous analysis. A key argument in favour of deregulation is that insider trading is a victimless crime. This argument finds its basis in the fact that insider trading occurs on anonymous sharemarkets. While the inside trader places their order in possession of an informational advantage, the counterparty to the trade ("the outsider") would have completed their side of the trade regardless. The outsider places their order at the price they deem worth trading free from any inducement by the insider. Taking this view, the outsider cannot argue

[132] International Organisation of Securities Commissions "Objectives and Principles of Securities Regulation" (May 2017) at 3.
[133] International Organisation of Securities Commissions "Objectives and Principles of Securities Regulation" (May 2003) at 1. See: Monique Egli Costi "Institutional Evolution and Characteristics of the International Organisation of Securities Commissions" 20 NZACL 199.
[134] IOSCO, above n 132, at 3.
[135] Brenda Hannigan *Insider Dealing* (2nd ed, Longman, London, 1994) at 6.

the insider caused them any loss.[136] In my opinion, this proposition can be cogently rebutted by the argument that the outsider likely would not have sold had they possessed the same non-public information as the insider.[137] Nevertheless, as Bainbridge identifies, it is purely fortuitous that an insider was counterparty to the transaction.[138] This means the outsider is a victim only in the sense that they have traded at an informational disadvantage that has been exploited by the insider; they were not induced by the insider. However, I argue confining the search for a victim to the parties to the trade is unduly myopic. The impersonal nature of the share market precludes ready identification of the insider that has exploited the outsider thus. Therefore, despite the existence of an individual victim, their exact identity is unclear; this erodes traders' trust in the market by engendering the suspicion that any trade may be made at an informational disadvantage. This conclusion segues into the principal moral justification for insider trading regulation: it offends against 'the market' by undermining equal access to information.

In terms of insider trading's broader harm to the market, it has been suggested by those against a prohibition that trading while less informed than others in the market is part of the "rough and tumble of financial life" and thus any losses (even those suffered due to insider trading) ought to be borne without complaint.[139] The argument can even be made that the outsider benefited from the insider trading to the extent any insider trading preceding the outsider's trade raised the price of the financial product.[140] It has been suggested this absence of an individual victim precludes the visitation of any harm on the broader market.[141] However, I demonstrate *supra* that the counterparty to an inside trade is harmed in some sense by an illegitimate informational disadvantage. Furthermore, while every trader in a market will inevitably be informed to different degrees, they enter into the "rough and tumble" on faith that they and all other traders have access to the same universe of available information.[142] Without this belief, impersonal markets would cease to function fairly; in the

[136] JAC Hetherington "Insider Trading and the Logic of the Law" (1967) Wis L Rev 720 at 723.
[137] Norman S Poser "Review: Insider Trading and the Stock Market by Henry G Manne" (1967) 53 Va L Rev 753 at 754.
[138] Stephen M Bainbridge "Insider Trading: An Overview" (24 October 1998) Social Science Research Network <www.ssrn.com> at 12.
[139] William H Painter "Inside Information: Growing Pains for the Development of Federal Corporation Law under Rule 10b-5" (1965) 65 Colum L Rev 1361 at 1386.
[140] Hetherington, above n 136, at 723.
[141] Bainbridge, above n 138, at 13.
[142] Jennifer Moore "What is really unethical about insider trading?" (1990) 9 Journal of Business Ethics 171 at 173.

absence of personal trust found in face-to-face markets, information must serve as the surrogate.[143] Therefore, the harm caused by insider trading is spread across every trader in the market by an erosion of the trust and confidence upon which share markets are premised. This conclusion forms the basis of moral arguments in favour of regulation that decry insider trading as unfair conduct.

Economic arguments

The economic arguments against prohibition also raise the seemingly victimless nature of insider trading, and this argument is noted in some of the economic literature.[144] The seminal economic argument for non-regulation was made over half a century ago by Henry G. Manne,[145] who completely eschewed moral arguments and argued that viewed through an economic lens insider trading is beneficial. Manne identified two benefits to insider trading: it promotes efficient and accurate pricing of securities without reliance on disclosure (which undoubtedly in Manne's time was more cumbersome than today) and provides an efficient means of compensating managers for their innovation.[146] Therefore, Manne's argument espouses that prohibiting insider trading delays incorporation of information into share prices, thereby increasing bid-ask spreads and volatility.[147] The efficient compensation justification has been roundly dismissed,[148] and has little bearing on the economic debate surrounding insider trading today.[149]

Manne's heavily theoretical economic argument has been criticised for its lack of empirical justification,[150] and was even denounced as possessing an "unworldly air".[151] However, more recent studies have robustly demonstrated the harm caused by insider trading and the effects

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[143] Ethiopis Tafara "Foreword" in Eilís Ferran and others *The Regulatory Aftermath of the Global Financial Crisis* (Cambridge University Press, New York, 2012) at xiv.
[144] Mark Schindler *Rumors in Financial Markets* (Wiley Finance, Chichester (West Sussex), 2007) at 40.
[145] Henry G Manne *Insider Trading and the Stock Market* (The Free Press, New York, 1966).
[146] Stephen M Bainbridge "Manne on Insider Trading" in Fred S McChesney (ed) *The Collected Works of Henry G. Manne* (Liberty Fund Inc, Indianapolis, 2009) at 3.
[147] Robert Baxt, Ashley Black and Pamela Hanrahan *Securities and Financial Services Law* (7th ed, LexisNexis, Chatswood (NSW), 2008) at 693.
[148] Briefly, because insider trading would allow managers to profit from failures as well as successful value creation. Manne's argument only considers compensation for the latter. See: Poser, above n 137, at 755.
[149] Richard W Painter "Insider Trading and the Stock Market Thirty Years Later" (1999) 50 Case W Res L Rev 305 at 309.
[150] Hetherington, above n 136, at 722.
[151] Poser, above n 137, at 756.

of prohibition, clearly demonstrating the economic importance of an insider trading prohibition.

Manne's efficient pricing justification for insider trading seems compelling in a vacuum. However, when subjected to a more rigorous inquiry the justification loses its weight. Gilson and Kraakman analysed Manne's argument, and found insider trading does have a perceptible effect on price,[152] albeit one that "functions slowly and sporadically".[153] This effect is referred to as the "derivately informed trading mechanism", involving two steps: first, information insiders trade with a barely perceptible price effect; secondly, uninformed investors detect the insider's price effect and trade on it. The trading by uninformed investors compounds until the market moves towards the correct price. In my view, this mechanism is far less efficient than Manne suggests. Gilson and Kraakman concur: they suggest that if deregulation of insider trading is to occur, some requirement that insiders disclose their information prior to trading ought to be imposed.[154] This refutation of Manne's market efficiency justification significantly weakens the economic argument for deregulation.[155]

The economic arguments in favour of prohibition are reinforced by empirical research as to the adverse effect of insider trading on market microstructure, namely the bid-ask spread. In a market, the bid-ask spread is the difference between a security's buy and sell offer prices, and is a measure of liquidity and transaction costs. Market makers provide liquidity in markets by undertaking to buy and sell at certain prices, seeking to profit from the bid-ask spread (which can be conceptualised as the fee the market maker charges for providing liquidity).[156] Chung and Charoenwong empirically demonstrated the negative effect of insider trading on bid-ask spreads, concluding that market makers protect themselves against insider trading by establishing larger bid-ask spreads for stocks with a higher incidence of insider trading.[157] This study employed SEC data on reported trades made by corporate insiders.[158] Due to concerns about selection bias, incidences of illegal insider trading did not form part of the

[152] Ronald T Gilson and Reineir H Kraakman "The Mechanisms of Market Efficiency" (1984) 70 Va L Rev 549.
[153] Gilson and Kraakman at 631.
[154] Gilson and Kraakman at 632.
[155] Bainbridge, above n 138, at 9.
[156] Pu Shen and Ross M Starr "Market-makers' supply and pricing of financial market liquidity" (2002) 76 Econ Lett 53 at 53.
[157] Charlie Charoenwong and Kee H Chung "Insider Trading and the Bid-Ask Spread" (August 1998) 33 The Financial Review 1 at 17.
[158] Charoenwong and Chung at 3.

data set given the likelihood that not all prohibited insider trading is detected. Regardless, the principles of this study apply equally to incidences of prohibited insider trading.[159]

The identified increase in bid-ask spreads occurs because market makers consistently "lose" on trades with insiders, who can obtain reliable profits due to their superior information.[160] Accordingly, insider trading increases market makers' adverse selection costs and erodes their profitability. These costs are passed on to other investors in the form of increased bid-ask spreads.[161] Prohibiting insider trading insulates market makers from these costs.[162] Chung and Charoenwong postulate that liquidity providers infer the existence of insider trading by trade size, and increase bid-ask spreads when unusually large transactions take place.[163] As the bid-ask spread represents liquidity and transaction costs in a market, insider trading adversely affects both of these market characteristics, and consequentially increases the cost of equity.

Chung and Charoenwong used data from the New York Stock Exchange ("NYSE") to reach their conclusions.[164] The NYSE designates market makers for particular securities,[165] however, the NZX operates a purely order-driven market,[166] which does not involve designated market makers; prices are set by "liquidity providing" limit orders placed by buyers and sellers (who can be described as "implicated market makers"[167]).[168] Therefore, the effects of insider trading on market makers do not translate perfectly to the New Zealand context. Regardless, the theory behind the increased bid-ask spread (namely, increased adverse selection costs) applies equally to order-driven markets.[169] Accordingly, insider

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[159] Bart Frijns, Adam Gilbert and Alireza Tourani-Rad "Elements of Effective Insider Trading Laws: A Comparative Analysis" (paper presented to the 11th New Zealand Finance Colloqium, 8 February 2007) at 3.
[160] Stanislav Dolgopolov "Insider Trading and the Bid-Ask Spread: A Critical Evaluation of Adverse Selection in Market Making" (2003) 33 Capital University Law Review 83 at 88-89.
[161] N P B Bollen, T Smith and R E Whaley "Modeling the bid/ask spread: On the effects of hedging costs and competition" (paper presented at the University of Otago Department of Finance Seminar Series, 17 August 2001) at 3.
[162] Bainbridge, above n 138, at 10.
[163] Charoenwong and Chung, above n 157, at 17.
[164] Charoenwong and Chung, above n 157, at 3.
[165] "The NYSE Market Model" <www.nyse.com>.
[166] Rasika Maduranga Withanawasam "Modelling Trade-Based Manipulation Strategies in Limit-Order Markets" (PhD thesis, University of Otago, 2013) at 14.
[167] Chenying He and others "Adverse selection costs: a study on the Chinese stock market" (2010) 4 Front Bus Res China 209 at n 3.
[168] *Warminger*, above n 97, at [8] and [18]. Note that trades can also be negotiated off-market between brokers: see *Warminger* at [17].
[169] Frijns, Gilbert and Tourani-Rad, above n 158, at 5.

trading's connection to increased bid-ask spreads is a compelling economic justification for an insider trading prohibition in New Zealand.

As alluded to *supra*, insider trading affects firms' cost of equity (in this sense, the return theoretically demanded by shareholders) by decreasing liquidity and increasing transaction costs. A study by Bhattacharya and Daouk sought to quantify this effect and concluded the enforcement of insider trading has a direct positive effect on the cost of equity by improving corporate governance[170] and an indirect effect by improving liquidity.[171] The latter conclusion corroborates Chung and Charoenwong's conclusions and applies them to the cost of capital. Notably, the positive effects of regulation were only observed following successful enforcement;[172] Coffee postulates that the SEC's relative enforcement intensity can explain the United States' comparatively lower cost of capital on the international stage.[173] This is an important qualification against the backdrop of New Zealand's weak enforcement record.

It is worth noting the complexities of the sharemarket (and the inherent secrecy of undetected insider trading) make it difficult to conclusively quantify the effect of insider trading. However, the empirical evidence clearly suggests insider trading is economically undesirable.[174] This suggestion firmly refutes Manne's argument for deregulation and establishes the importance of effectively enforced insider trading laws.

Chapter 3: Different theories of insider trading regulation

Insider trading prohibitions are generally predicated on one of two key theories: market fairness or fiduciary. This Chapter will explore the theoretical differences between the two to conclude that market fairness is appropriate for the New Zealand context. A comparison of New Zealand's formerly fiduciary-based regime under the SAA with the United States' common law prohibition will demonstrate the desirability of a market fairness prohibition in New Zealand.

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[170] That is, by forcing directors to create value, rather than profit by trading on the basis of negative company information. See the refutation of Manne's efficient compensation justification at n 148.
[171] Utpal Bhattacharya and Hazem Daouk "The World Price of Insider Trading" (February 2002) 57 J Finance 75 at 92-93.
[172] Bhattacharya and Daouk at 75.
[173] John Coffee "Law and the Market: The Impact of Enforcement" (2007) 156 U Pa L Rev 229 at 308-309.
[174] Gill North "The Australian insider trading regime: Workable or hopelessly complex?" (Research paper, University of Western Australia, 2009) at 3.

Market fairness rationale

Basis of the rationale

In New Zealand, the policy justification for insider trading regulation intersects the moral and economic arguments in favour of regulation that were explored in Chapter 2: the current regime is based on the twin notions of market fairness and market efficiency.[175] This rationale is occasionally referred to as the "access to information" theory,[176] and its New Zealand guise is modelled on its Australian counterpart.[177]

The market fairness rationale incorporates the moral arguments in favour of regulation, maintaining that all investors in a market should have equal access to information.[178] This is intended to prevent insiders exploiting informational advantages and the consequential negative effects of insider trading on market fairness and investor confidence.[179] It is clear New Zealand policymakers do not consider insider trading to be part of the "rough and tumble of financial life". Equally important to the rationale is the outward appearance of fairness,[180] in order to maintain investor confidence, which encourages savers to invest their surplus funds in the market. The importance of overt fairness in attracting investors to the market ties into the market efficiency rationale.

The market efficiency limb of the New Zealand regime is based on the idea that unpunished insider trading will create a perception of unfairness and deter investors from the market.[181] This perception may drive investors away from the public markets towards safer investment opportunities,[182] which would have adverse consequences for market liquidity, cost of capital and ease of fundraising for New Zealand firms and investors.[183] The picture of insider trading's harm painted by the economic evidence outlined in Chapter 2 undoubtedly diffuses through this rationale.

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[175] Trish Keeper "Insider Trading" in Victoria Stace and others *Financial Markets Conduct Regulation: A Practitioner's Guide* (LexisNexis, Wellington, 2014) 267 at 270.
[176] Baxt, Black and Hanrahan *Securities and Financial Services Law*, above n 147, at 692.
[177] Trish Keeper, above n 175, at 270.
[178] *Sansom*, above n 91, at [24].
[179] Stace, above n 21, at 284.
[180] Paul Barnes *Stock Market Efficiency, Insider Dealing and Market Abuse* (Gower, Surrey, 2009) at 9.
[181] Cabinet Paper "Review of Securities Trading Law: Insider Trading" (24 July 2003) at [4].
[182] At [11].
[183] At [4].

In the New Zealand regime, the twin rationales of efficiency and fairness are intrinsically linked. The fairness rationale is employed to maintain investor confidence, so the market can continue to function as an efficient source of investment opportunities for savers. Therefore, the two limbs can be treated as a cohesive whole. Accordingly, the twin rationales will henceforth be referred to together as the "market fairness rationale". Regimes that incorporate this rationale (by eschewing a requirement that an insider have any connection to the issuer in which they trade) will be referred to as "market fairness regimes".

Origin of the market fairness rationale

As is often the case in securities law,[184] the principles underlying the market fairness rationale find their intellectual origin in the United States' jurisprudence. Insider trading in the United States is regulated by rules promulgated by the Securities and Exchange Commission ("SEC") under § 10(b) of the Securities Exchange Act of 1934;[185] SEC r 10b-5 was made prohibiting securities fraud in 1948, and it remains the key rule prohibiting insider trading today.

The United States' prohibition is interpreted within a substantive legal tradition that allows a liberal interpretation that would likely be inconsistent with New Zealand's formal legal system. Substantive, in this sense, means that courts are prepared to advance moral, economic and political considerations by taking a relatively flexible approach to statute and precedent. In *SEC v Texas Gulf Sulphur Co*, the Court of Appeals for the Second Circuit emphasised the access to information principle in its interpretation of the prohibition, holding that insider trading ran counter to the "justifiable expectation of the securities marketplace that all investors trading on impersonal exchanges have relatively equal access to material information".[186] In *Shapiro v Merrill Lynch, Pierce, Fenner & Smith Inc* the same court held r 10b-5 served to ensure "fair dealing in the securities markets by promoting full disclosure … so that an informed judgment can be made by all investors who trade in such markets".[187] These ideas represent an early expression of the market fairness rationale. However, as I will analyse shortly, this train of jurisprudential thought did not survive into the present day in the United States, having been stopped in its tracks by the Supreme Court in *US v Chiarella*.[188]

[184] Loke, above n 61, at 124.
[185] Securities Exchange Act 15 USC § 78a et seq.
[186] *SEC v Texas Gulf Suphur Co* 401 F 2d 833 at 848 (1968).
[187] *Shapiro v Merrill Lynch, Pierce, Fenner & Smith Inc* 495 F 2d 228 at 235 (2d Cir 1974).
[188] *US v Chiarella* 445 US 222 (1980).

The ideas behind the United States dicta on market fairness were incorporated into Australian policy in 1981 by the Committee of Inquiry into the Australian Financial System ("the Campbell Committee"), which adopted the familiar principles of investor confidence and efficiency as a basis for the existing fiduciary insider trading prohibition:[189]

> The object of restrictions on insider trading is to ensure the securities market operates freely and fairly, with all participants having equal access to relevant information. Investor confidence, and thus the ability of the market to mobilise savings, depends on the prevention of the improper use of confidential information.

Interestingly, in 1981 the Australian insider trading regime was fiduciary-based: the statute required that a person had to be connected in some way to the issuer in which they were trading to be deemed an "insider".[190] This demonstrates the degree of overlap between the two rationales: the Campbell Committee adopted these principles without voicing any particular criticism of the fiduciary regime. The Securities Commission similarly recognised the importance of market fairness principles when recommending a fiduciary regime in New Zealand in 1987.[191]

A market fairness regime was not implemented in Australia until 1991, as part of a securities markets law reform initiated by the Anisman[192] and Griffiths[193] Reports into insider trading (which were undertaken at the recommendation of the Campbell Committee[194]).[195] These reports recommended broadening the scope of the insider trading prohibition from its fiduciary form by removing the requirement that insiders must have some connection to the issuer.[196] This was seen as "too restrictive" and an unnecessary complication of the regime,

[189] Committee of Inquiry into the Australian Financial System "Australian Financial System: Final Report of the Committee of Inquiry" (AGPS, 1 September 1981) at 382.
[190] Securities Industry Act 1980 (Cth), s 128.
[191] Securities Commission *Insider Trading: Report to the Minister of Justice by the Securities Commission* (18 December 1987) at 4.4.
[192] Philip Anisman *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* (National Companies and Securities Commission 1986).
[193] Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs "Fair Shares for All: Insider Trading in Australia" (11 October 1990).
[194] Committee of Inquiry into the Australian Financial System, above n 188, at 383.
[195] Corporations Legislation Amendment Act 1991 (Cth), sch 4. See also: Keith Kendall and Gordon Walker "Insider trading in Australia" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) 365 at 366-367.
[196] Kendall and Walker at 366-367.

following *Hooker Investments v Baring*, in which the requisite connection could not be established.[197] The removal of the "person connection"[198] requirement was the principal change enacted as part of the reform,[199] and brought the "information connection" regime upon which New Zealand's was modelled into existence. Malaysia subsequently reformed its fiduciary-based prohibition to a market fairness regime in 1997.[200] A market fairness regime is also employed in the United Kingdom[201] and Singapore.[202] These prohibitions are drafted in substantially similar manners. It is clear that from an international perspective, market fairness regimes are a minority; most jurisdictions continue to base their insider trading regimes on a fiduciary rationale.[203]

Theoretical implications of the market fairness rationale

New Zealand's current market fairness regime has a far broader capture than the former prohibition found in the SAA due to the information connection requirement (compared to the personal connection that was central to the SAA).

An example of a market fairness regime's broad capture in the Australian context was seen in *R v Rivkin*.[204] Rene Rivkin, a well-known and controversial stockbroker,[205] was in the process of selling his house in an affluent harbourside suburb of Sydney, Australia.[206] The founder and chief executive of Impulse Airlines expressed an interest in the property, but told Rivkin he was waiting on the merger of Impulse Airlines with Qantas and made his offer to purchase the property conditional on the merger's completion. He also told Rivkin he believed regulatory approval for the merger would be forthcoming.[207] Rivkin proceeded to purchase 50,000 Qantas shares for approximately $139,000.[208] The shares were subsequently sold for a

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197 *Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd* (1986) 10 ACLR 462; Report of the House of Representatives Standing Committee on Legal and Constitutional Affairs, above n 192, at 23.

198 "Review of Securities Trading Law: Insider Trading", above n 181, at [17].

199 Paul Redmond "A Short History of Securities Regulation in Australia" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (1st ed, Oxford University Press, Auckland, 1994) 90 at 101.

200 Securities Industry (Amendment) Act 1997 (Malaysia), s 25.

201 Criminal Justice Act 1993 (UK), pt 5.

202 Securities and Futures Act 2001 (Singapore), s 219.

203 "Review of Securities Trading Law: Insider Trading", above n 181, at [20].

204 *R v Rivkin* [2003] NSWSC 447.

205 "Controversial financier dies" *The Special Broadcasting Service* (online ed, Australia, updated 22 August 2013).

206 *Rivkin* at [5].

207 At [11].

208 At [21].

profit of a mere $2,664.94 (bear in mind Rivkin's property ultimately sold for $8.15 million[209]).[210] Under the Australian market fairness regime, it was sufficient that Rivkin was in possession of the merger information when he traded, despite him having no personal connection to Qantas. Therefore, *Rivkin* is an example of a market fairness regime capturing undesirable conduct that would not be caught under a fiduciary regime such as the SAA.

The broader application of the Australian market fairness regime was also demonstrated in *CDPP v Hill*.[211] Lukas Kamay was sentenced to seven years and three months imprisonment for his role in an insider trading scheme in which Christopher Hill of the Australian Bureau of Statistics provided him with key economic indicators before they were made public. Kamay used this advance information to trade on the foreign exchange derivatives market.[212] It seems clear Kamay would not have been liable under Australia's former fiduciary regime: the statute only applied to trading in the securities of body corporates and did not contemplate derivatives.[213] Accordingly, there was no basis by which to establish a personal connection between Kamay or Hill and the Australian dollar. However, under a market fairness regime, Kamay's trading eroded the broader principle of equal access to information, thereby contravening the current Australian prohibition.[214] A similar outcome would be likely to result under the FMCA if this trading occurred in New Zealand: FX swaps are "derivatives" under the FMCA per s 8(4)(a)(i),[215] and if they were approved for trading on a licensed market[216] would be "quoted derivatives" per s 6. The possession of confidential statistics relating to the Australian dollar, therefore the exchange rate underlying the FX swaps, would make Kamay an information insider in respect of the quoted derivatives under s 234(3)(a)(ii). Accordingly, trading in the FX swaps would be captured by the prohibition under s 241(2).[217] The broader capture of a market fairness regime demonstrated by *Rivkin* and *Hill* is consistent with the moral and economic justifications for insider trading regulation identified

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[209] Realestate.com.au "5 Rosebay Avenue, Bellevue Hill, NSW 2023" <www.realestate.com.au>.
[210] At [29].
[211] *Commonwealth Director of Public Prosecutions v Hill and Kamay* [2015] VSC 86.
[212] *Hill and Kamay* at [18]-[22].
[213] Securities Industry Act 1980 (Cth), s 128.
[214] *Hill and Kamay*, above n 210, at [46].
[215] Swap agreements also fall within the inclusive definition of "derivatives" under s 8(4)(b)(iii).
[216] Such as the Intercontinental Exchange derivatives market. See: FMA "Licensed providers" <www.fma.govt.nz>.
[217] For more information on the New Zealand derivatives markets, see: Christian Hawkesby "A primer on derivatives markets" 62 2 Reserve Bank Bulletin.

in Chapter 2: the harm of insider trading is visited on the entire market irrespective of who the trader is, or how they obtained their information.

In New Zealand, the market fairness regime has yet to capture insider trading by persons outside the class of traditional insiders. For example, Jeffrey Honey obtained his inside information concerning ERoad's sales in his capacity as insights and analytics manager.[218] Honey's activity would still have been captured under the SAA prohibition, as the information was clearly obtained "by reason of" his employment.[219] Similarly, Mark Talbot obtained his inside information by reason of his position as CFO of VMOB.[220] Hamish Sansom (who received inside information from Honey) was an information insider of ERoad, and the FMA alleged the trading prohibition under the FMCA was contravened accordingly. Sansom was ultimately acquitted by a High Court jury.[221] However, it seems Sansom's trading was outside the bounds of the old regime under the SAA, as the inside information was not received in confidence,[222] as was required under the SAA.[223] Had Sansom been convicted, the broader ambit of the market fairness regime would have captured conduct outside the bounds of the SAA for the first time.

A further implication of the market fairness rationale is it conceives 'the market' on which insider trading occurs as a matter of public importance, rather than a means of facilitating purely private transactions. This goes to the commonly held perception of insider trading being a "victimless crime": in the absence of an individual victim, the market as an abstraction is the entity injured by insider trading. As fiduciary theory has its basis firmly in private law,[224] a move towards the market fairness rationale necessarily implies that private law does not provide appropriate means of redress for insider trading. In my view, this implication is theoretically sound: as discussed in Chapter 1, the anonymous nature of sharemarkets precludes private enforcement by injured counterparties, and it follows that the principle of *caveat emptor* is not a sound basis for insider trading regulation to be founded

[218] *Honey*, above n 1, at [4].
[219] SAA, s 3(1)(b).
[220] Financial Markets Authority "Former CFO to pay $150,000, barred for Securities Markets Act breaches", above n 111.
[221] Financial Markets Authority "ERoad – Hamish Sansom and Jeffrey Peter Honey", above n 110.
[222] *Haylock v Southern Petroleum No Liability* [2002] 3 NZLR 518 at [4].
[223] SAA, s 3(1)(c).
[224] Andrew S Gold and Paul B Miller (eds) "Introduction" in *Philosophical Foundations of Fiduciary Law* (Oxford University Press, Oxford, 2014) at 1.

upon in the present day.[225] Furthermore, the unique characteristics of New Zealand's capital markets to some extent necessitate a public law approach to insider trading: low retail ownership on the NZX suggests few New Zealanders choose to participate directly in the secondary market.[226] Rather, for the "typical" New Zealander, their exposure to the market occurs through Kiwisaver, of which just over half of the population are members.[227] Accordingly, it is ill-founded to treat insider trading as a purely private matter.

The public conception of the sharemarket underlying the market fairness rationale is consistent with the increased regulation of the financial sector, especially banks, that has taken place following the economic effects of the 2008 Global Financial Crisis ("GFC").[228] In New Zealand today, a well-functioning finance sector is considered vital to long-run economic growth,[229] and policy is directed towards developing and supporting capital markets.[230] This supports the premise that the sharemarket is a matter of public importance, and that the harm insider trading causes to the market itself warrants enforcement by a public authority (in New Zealand, the FMA). Therefore, it is my view that the market fairness rationale is appropriate for New Zealand given the public treatment of the financial sector in the post-GFC regulatory context.

A further issue with the New Zealand market fairness regime concerns the criminalisation of insider trading. As the public treatment of the sharemarket underlying the market fairness rationale implies there is no identifiable individual victim, private law civil remedies are not effective in regulating insider trading. Accordingly, a public enforcement agency is necessary.[231] However, criminalisation is not a mandatory element of a public enforcement

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[225] Donald C Langevoort "Words From on High About Rule 10b-5: *Chiarella*'s History, *Central Bank*'s Future" 20 Del J Corp L (1995) 865 at 871.
[226] Haiyan Jiang "Three Essays on Ownership Concentration in New Zealand" (PhD thesis, Lincoln University, 2009) at 2.
[227] Financial Markets Authority "Kiwisaver Annual Report 2018" (9 October 2018) at 2.
[228] Toby Fiennes, Head of Prudential Supervision at the Reserve Bank of New Zealand "Regulation and the Financial System" (speech to the Law and Economics Association of New Zealand, Wellington, 19 June 2013) at 11.
[229] Rosborough, Reid and Hunt, above n 8, at 6. Compare this sentiment against the tenor of the introduction to: Department of Justice *Report of the Sharemarket Inquiry Establishment Unit* (1989).
[230] Rosborough, Reid and Hunt, above n 8, at 11.
[231] Judged by the United States' experience, even when insider trading is seen as a private matter, private litigation has not been an effective enforcement method. See: James D Cox "An Economic and American Perspective of Insider-trading Regulation in Australia and New Zealand" in Gordon Walker and Brent Fisse (eds) *Securities Regulation in Australia and New Zealand* (1st ed, Oxford University Press, Auckland, 1994) 621 at 627.

model. In New Zealand, criminal liability for insider trading can command a prison sentence of up to five years,[232] yet under a market fairness rationale no loss is caused to “any person” by insider trading, as the market suffers the injury. Given the disagreement surrounding the immorality of insider trading explored in Chapter 2 and the existence of a civil liability regime requiring a lower standard of proof, it is certainly arguable whether hurting ‘the market’ provides sufficient justification for imprisonment in New Zealand.[233] The criminal penalties for insider trading seem to have been introduced for their deterrent effect,[234] although the effectiveness of this deterrence has been questioned.[235] The theoretical difficulty presented by criminal penalties for insider trading reveals a conceptual issue that is not as present when insider trading is treated as a private matter, as is the case under a fiduciary rationale.

Fiduciary rationale

Despite the importance of the market fairness rationale to the New Zealand regime, the fiduciary rationale underpins the majority of insider trading prohibitions worldwide.[236] Fiduciary-based regimes may take a variety of forms; I suggest below that each specific form adopted will depend on the “vision” of law held in the jurisdiction.[237] However, the determinative factor of a fiduciary regime is the requirement for a personal connection of some sort between an insider and the issuer in which they trade.[238] A comparison of the former New Zealand regime under the SAA with the United States’ prohibition demonstrates how prohibitions based on the fiduciary rationale may assume quite dissimilar forms.

Basis of the rationale

At its crux, the fiduciary rationale conceptualises insider trading as a breach of some relationship of trust and confidence, hence at the highest level some “person connection” is

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[232] FMCA, s 244(2)(a).
[233] See: John Anderson “Greed, Envy and the Criminalisation of Insider Trading” (2014) Utah L Rev 1 at 1.
[234] (14 December 2004) 622 NZPD 18039.
[235] Bart Frijns, Aaron Gilbert and Alireza Tourani-Rad “Do Criminal Sanctions Deter Insider Trading?” (paper presented to the 15th New Zealand Finance Colloqium, 10 February 2011) at 5.
[236] “Review of Securities Trading Law: Insider Trading”, above n 181, at [20].
[237] P S Atiyah and R S Summers *Form and Substance in Anglo-American Law: A Comparative Study in Legal Reasoning, Legal Theory and Legal Institutions* (Clarendon Press, Oxford, 1987) at 5.
[238] For example, this connection may take the form of a fiduciary duty (such as in the USA), or a connection deemed by statute (such as the former New Zealand regime). See: Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) at 6, 367 and 390-391.

necessary to found liability under a fiduciary regime. As will become clear, the fiduciary theory of trust law often influences regimes without express incorporation.

In its purest form, a fiduciary relationship entails that one person ("the fiduciary") owes duties to another ("the beneficiary"). The scope of these duties is encompassed by the fiduciary's overarching duty of loyalty to the beneficiary. The duty of loyalty is strict,[239] and is the "distinguishing obligation" of a fiduciary relationship. A number of other duties flow from this duty:[240]

> The principal is entitled to the single-minded loyalty of his fiduciary. This liability has several facets. A fiduciary must act in good faith; he must not make a profit out of his trust; he must not place himself in a position where his duty and his interest may conflict; he may not act for his own benefit or the benefit of a third person without the informed consent of his principal.

These duties all inform the fiduciary rationale as it applies to insider trading. In a New Zealand context, the fiduciary rationale (as it informed the SAA regime) analogises the relationship between company directors (and often others with a connection to the company) and shareholders with the fiduciary relationship found in trust law.[241] It does not involve a pure application of fiduciary theory, but it entails that if directors and other company officers use information obtained by reason of their position within the company to trade on their own account, they will have breached the duty of loyalty owed to shareholders.

In New Zealand law, a director may also owe true fiduciary duties to a shareholder in special circumstances. In *Coleman v Myers*,[242] the Court of Appeal refused to impose a general fiduciary duty on directors but found fiduciary duties were owed in that case due to the particular family circumstances of the transaction.[243] The Court of Appeal confirmed in *Holmes v Kiriwai* that *Coleman* is still good law,[244] despite the Companies Act 1993 imposing an analogous statutory restriction on share dealings by directors.[245]

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[239] *Boardman v Phipps* [1966] UKHL 2.
[240] *Mothew v Bristol & West Building Society* [1998] Ch 1 at 18 per Lord Millett; endorsed in *Stevens v Premium Real Estate Ltd* [2009] NZSC 15 at [67].
[241] Loke, above n 61, at 131.
[242] *Coleman*, above n 54.
[243] *Coleman* at 330.
[244] *Holmes v Kiriwai Consultants Ltd* [2015] NZCA 149 at [59].
[245] Companies Act 1993, s 149.

As *Coleman* remains good law, and noting that it predated the SAA by over a decade, it is clear New Zealand's fiduciary insider trading regime supplemented pre-existing trust principles, rather than subsuming them into the prohibition. This is consistent with New Zealand's formal approach to fiduciary theory: it would be a departure from established principles of trust law to deem the relationship between two parties to a sharemarket transaction fiduciary in nature,[246] as there is no trust and confidence reposing in either party,[247] given the anonymous nature of the market.

How the fiduciary rationale may manifest itself

A fiduciary regime may assume a variety of forms. A comparison of the SAA's person connection regime and the United States' modern common law prohibition will reveal two different guises based on a fiduciary rationale.

The United States' approach to law is more substantive and flexible than the formalistic English legal tradition inherited by New Zealand.[248] The United States judiciary imputes relatively less importance to statute in decisionmaking compared to New Zealand,[249] and treats legal rules as incorporating a wide matrix of background morality and purpose.[250] Conversely, in New Zealand, statute is seen as the formal expression of the sovereign's will, and is interpreted to give effect to its purpose.[251] In the absence of statute, the doctrine of *stare decisis* is adhered to by New Zealand courts in the interests of certainty and clarity.[252] Relevantly, the United States treatment of fiduciary theory is far more liberal than New Zealand's: it has been stretched "beyond what the English and Commonwealth lawyer would consider the legitimate bounds of the fiduciary concept".[253] Therefore, the United States' insider trading prohibition exists in a substantive legal universe, with a consequentially different manifestation. This demonstrates why New Zealand's formerly fiduciary rationale

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[246] New Zealand lawmakers are seemingly opposed to analogising trust concepts with non-fiduciary relationships, in keeping with the formal tradition of our legal system. For example, s 111 of the FMCA renamed the person charged with representing holders of debt securities from "trustee" to "supervisor" (compare: Securities Act 1978, s 2).
[247] *Chirnside v Fay* [2007] NZSC 68 at [80].
[248] Atiyah and Summers, above n 236, at 32.
[249] Atiyah and Summers, above n 236, at 96.
[250] Atiyah and Summers, above n 236, at 103.
[251] Nathanael Starrenberg "Interpretive Theories in New Zealand Bill of Rights Jurisprudence" (2004) 10 Auk U L Rev 115 at 116.
[252] Duncan Webb, Katherine Sanders and Paul Scott *The New Zealand Legal System: Structures and Processes* (5th ed, LexisNexis, Wellington, 2010) at 71.
[253] Loke, above n 61, at 128.

under the SAA is best treated as an analogy with trust principles rather than a statutory adoption of fiduciary theory.

(a) New Zealand: the Securities Amendment Act 1988

As explored in Chapter 1, the first New Zealand insider trading prohibition established by the SAA took a narrow approach compared to the current market fairness regime under the FMCA. The regime under the SAA was entirely statute-based, and required insiders to have some degree of personal connection to the listed issuer: the prohibition applied only to persons that had obtained information by reason of a special relationship with a public issuer, or had received information in confidence from another person in such a special relationship. Furthermore, the prohibition treated insider trading as a purely private matter: enforcement was left to the public issuer or the counterparty to the trade.[254] The Securities Commission did not explicitly adopt fiduciary theory as a basis for the prohibition in its 1987 proposal,[255] but acknowledged that "fiduciary theory provides strong support for the principles we recommend".[256]

The SAA prohibition demonstrates one way in which the fiduciary rationale can give a basis to a prohibition without expressly incorporating strict principles of trust law. In fact, it was commented that a key development of the SAA regime was that it did not require plaintiffs to establish a fiduciary relationship when alleging insider trading,[257] and the Securities Commission framed the prohibition as obligation based, rather than property (or information) based.[258] Accordingly, the prohibition reached beyond "pure" insiders owing duties to the company; insiders that received information in confidence were also implicated. The SAA regime suggested a very private treatment of the sharemarket given that it only contemplated private enforcement (the Securities Commission had no power to pursue insider trading until

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[254] Adrian van Schie *Insider Trading, Nominee Disclosure and Futures Dealing: An Analysis of the Securities Amendment Act 1988* (Butterworths, Wellington, 1994) at 31. The Securities Commission was not empowered to publicly pursue private causes of action until 2002. See: Securities Markets Amendment Act 2002, s 13.
[255] Securities Commission *Insider Trading: Report to the Minister of Justice by the Securities Commission* (18 December 1987) at 4.9.5(a).
[256] At 4.5.4.
[257] Peter Ratner and Cathy Quinn "Securities Amendment Act 1988: An Analysis of the Insider Trading and Disclosure Rules for the Legal Profession" (New Zealand Law Society seminar, March 1990) at 1.1.
[258] Partly due to the perceived nascence of intellectual and intangible property law at the time. See: Securities Commission, above n 254, at 1.8.

2002)[259].[260] This juxtaposes sharply with the conception of the financial sector as a public good in the present day.

The SAA statutory prohibition assumed a highly prescriptive form (certainly compared to the United States regime analysed *infra*). Not only was this appropriate for New Zealand's strict approach to trust principles: it was also consistent with the domestic courts' formal interpretive approach and the constitutional tradition of highly prescriptive legislation.[261] A prohibition couched in general terms "would have been stillborn in a culture steeped in the English interpretative tradition".[262] Accordingly, the New Zealand regime under the SAA represented an implementation of the fiduciary rationale in a relatively formal legal system. The prohibition assumed the form of a precisely worded statute, albeit at the expense of flexibility.

(b) United States of America: the Securities Exchange Act of 1934

The United States' current prohibition takes a drastically different form to the fiduciary SAA regime, and its evolution evinces the differences between the New Zealand and United States legal systems. While *Texas Gulf Sulphur* and *Shapiro* interpreted r 10b-5 (under § 10(b) of the Securities Exchange Act) as protecting equal access to information, the Supreme Court confirmed the fiduciary nature of the United States' prohibition in 1980 in *US v Chiarella*.[263] In *Chiarella*, the US Supreme Court substituted the market fairness rationale for a more conservative fiduciary standard,[264] primarily due to concern about "recognising a general duty between all participants in market transactions to forego actions based on material, nonpublic information".[265] The Court felt such a general duty should not be recognised without Congressional approval.[266] In this sense, *Chiarella* returned the developing interpretation of r 10b-5 to a fiduciary trajectory, which it has been argued the jurisprudence

[259] Securities Markets Amendment Act 2002, s 13.
[260] Gordon Walker and Andrew F Simpson "Insider trading law in New Zealand" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) 386 at 391.
[261] Securities Commission, above n 254, at 4.9.5(d).
[262] Loke, above n 61, at n 1.
[263] *US v Chiarella* 445 US 222 (1980).
[264] Donald C Langevoort "From *Texas Gulf Sulphur* to *Chiarella*: A Tale of Two Duties" (2018) 71 SMU Law Rev 835 at 837.
[265] *Chiarella* at 233.
[266] *Chiarella* at 228-30, 233.

was on before *Texas Gulf Sulphur* was decided.[267] The decision in *Chiarella* may also reflect a political dimension outside the scope of this dissertation: the United States is an outlier in terms of enforcement intensity,[268] and it has been written that the United States courts have "played an enormous role in prohibiting insider trading" alongside the SEC.[269] The Supreme Court in *Chiarella* perhaps took a conservative approach to the nascent market fairness regime due to this unique regulatory context.

In a formal legal system, a decision such as *Chiarella* may be seen as authoritative. However, the Supreme Court proceeded to extend the interpretation of r 10b-5 in subsequent cases. In *Dirks v SEC* the Supreme Court qualified its decision in *Chiarella* in holding a fiduciary must breach their duty for their personal benefit to attract liability.[270] Simultaneously, however, the Court confirmed r 10b-5's capture extended beyond the class of "classical insiders" identifiable under traditional fiduciary principles; outsiders who received information from a fiduciary could incur derivative liability as tippees or as "constructive insiders".[271] While this extension was still founded upon fiduciary theory,[272] it undoubtedly broadened the scope of *Chiarella*'s fiduciary interpretation.

Despite *Dirks*' broader ambit, the application of the United States prohibition to trading on the basis of non-public information obtained from a source other than the issuer (such as occurred in *Rivkin*)[273] remained unclear.[274] As the decisions in *Chiarella* and *Dirks* had been unfavourable for the SEC, it began propounding a new theory of insider trading to rectify the existing ambiguity: the misappropriation theory, the validity of which had been left open in *Chiarella*. This interpretive theory posited that r 10b-5 was breached if a person (the fiduciary) used information obtained from their principal for personal gain and did not disclose having done so. The Supreme Court was split on the misappropriation theory in

[267] Based on the Supreme Court decision in *SEC v Capital Gains Research Bureau* 375 US 180 (1963). See: A C Pritchard "Launching the insider trading revolution: *SEC v Capital Gains Research Bureau*" in Stephen M Bainbridge (ed) *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) 33 at 46.
[268] See: Coffee, above n 173, at 245.
[269] Nicholas Ryder *Financial Crime in the 21st Century: Law and Policy* (Elgar, Cheltenham, 2011) at 151.
[270] *Dirks v SEC* 463 US 646 at 659 (1983).
[271] *Dirks* at 655 n 14.
[272] By analogising insider trading liability with the liability of a third party that knowingly participates in a breach of trust. See: Loke, above n 61, at 130.
[273] *Rivkin*, above n 203.
[274] Stephen M Bainbridge (ed) "An overview of insider trading law and policy" in *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) 1 at 7.

Carpenter v US, but expressly endorsed it as a basis for insider trading liability in *US v O'Hagan*:[275]

> Under this theory, a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality, defrauds the principal of the exclusive use of that information.

The Supreme Court noted in *O'Hagan* that the misappropriation theory complements the "classical" fiduciary rationale,[276] bridging the gap revealed in *Chiarella* and *Dirks*. In my view, the adoption of the misappropriation theory signifies the point at which the United States' prohibition ceased to be fiduciary in a traditional sense; this evinces the inevitable shortcomings of the rationale.

In recent years, United States courts have dealt with cases of insider trading falling outside even the misappropriation theory. In *SEC v Dorozhko* a hacker stole material, non-public information about a company's declining earnings.[277] He then shorted the shares for a substantial profit. The Second Circuit held that even if an information insider does not have a fiduciary duty to abstain from trading (under either the fiduciary or misappropriation theory), they can still be liable for insider trading under r 10b-5 for breaching a general duty not to mislead.[278] This decision has been characterised as a joint effort by the SEC and the Second Circuit to subvert the Supreme Court's fiduciary theory, and perhaps represents the dawn of the "post-fiduciary duty era".[279]

(c) The New Zealand and United States' regimes compared

Comparing the SAA with the current United States regime demonstrates the different forms a fiduciary regime may take and reveals the difficulties inherent to the employment of a fiduciary prohibition in New Zealand's formal legal system.

[275] *United States v O'Hagan* 521 US 642 at 652 (1997).
[276] *O'Hagan* at 652.
[277] *SEC v Dorozkho* 574 F 3d 42 (2d Cir 2009).
[278] *Dorozkho* at 49.
[279] Stephen M Bainbridge (ed) "Regulating insider trading in the post-fiduciary duty era: equal access or property rights?" in *Research Handbook on Insider Trading* (Elgar, Cheltenham, 2013) 80.

The Supreme Court's move at common law from the fiduciary theory in *Chiarella* to the wide-ranging misappropriation theory in *O'Hagan* (while ostensibly clinging to a fiduciary rationale) demonstrates how the United States' substantive vision of law has let the fiduciary rationale germinate into a broad regime that "goes further along the line toward the parity of information paradigm".[280] It has even been suggested that the fiduciary theory has been substantially eviscerated from the regime by decisions such as *Dorozhko*.[281]

Viewed pragmatically, I suggest that the United States' current insider trading prohibition captures a similar range of conduct to the New Zealand market fairness regime under the FMCA;[282] the key difference being that the United States' prohibition is still founded upon a notion of personal connection that has been "stretched to its breaking point".[283] Accordingly, in the present day, the distinction between New Zealand's current regime and United States' is theoretical, rather than practical.

When the SAA fiduciary prohibition was enacted in New Zealand in 1988, the decision in *Dirks* was five years old. In my view, the SAA's prescriptive definition of "insider" was functionally equivalent to the class of constructive insider created in *Dirks*. I suggest the respective prohibitions assumed their distinct forms at that point in time due to the different visions of law of each jurisdiction: New Zealand's formal interpretive tradition would have been ill-equipped to deal with a broadly phrased provision such as r 10b-5. Likewise, the United States' liberal interpretive tradition necessitated a wide-ranging statute and facilitated the rapid evolution of the prohibition at common law. New Zealand's lawmaking process, in which change emanates from Parliament, did not keep pace with the United States' jurisprudence. Therefore, there was a temporary divergence between the regimes perhaps best represented by the endorsement of the misappropriation theory in *O'Hagan* in 1998. However, as is demonstrated, a shift to a market fairness regime in New Zealand has led to a functional convergence of the two regimes. The current equivalence of the two regimes is demonstrated by the admission of Christopher Cox, former SEC Chairman, that the

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280 Loke, above n 61, at 170.
281 Bainbridge, above n 279, at 80.
282 So that "a party with no ties to a corporation or any of its employees may still violate insider trading laws". See: Cichos, above n 212, at 391.
283 Bainbridge, above n 279, at 86.

misappropriation theory was "merely a pretext for enforcing equal opportunity in information".[284]

I suggest that each jurisdiction's rationale is a product of its specific legal processes. In the United States, the courts were empowered by a general statutory framework and a substantive legal tradition to adapt the fiduciary theory into a wide-ranging prohibition.[285] In New Zealand, change occurred through the law reform process.[286] This allowed the rationale behind insider trading to be revisited and led to the adoption of the market fairness rationale. In the United States jurisprudence, it appears the market fairness rationale now forms a subtext to the prohibition.

Based on the foregoing analysis, I suggest the SAA (as it was enacted) adopted a regime that mirrored the United States' prohibition under *Dirks*. Subsequently, the United States' law metamorphosed into a wide-ranging prohibition that today scarcely retains a fiduciary character (at least as fiduciary theory is understood in New Zealand). The New Zealand regime did not keep pace with this change until the market fairness regime was adopted; now, the regimes appear to capture similar conduct. It has even been said that the Australian regime (thus, by proxy, New Zealand's regime) has a sophistication surpassing the United States',[287] and a market fairness rationale has been suggested for the United States due to its conceptual clarity.[288] Therefore, the distinction between the modern market fairness and fiduciary rationales seems purely theoretical.

Applicability of the fiduciary rationale to New Zealand today

Notwithstanding the significant differences between the FMCA and United States prohibitions, it is worth addressing the theoretical implications that would arise if New Zealand was to adopt a fiduciary regime today. This hypothetical demonstrates the superiority of the current market fairness regime.

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[284] Charles C Cox and Kevin S Fogarty "Bases of Insider Trading Law" (1988) 49 Ohio St L J 353 at 366.
[285] Baxt, Black and Hanrahan *Securities and Financial Services Law*, above n 147, at 696.
[286] Spearheaded by the Securities Commission. See: Peter Fitzsimons "The New Zealand Securities Commission: The Rise and Fall of a Law Reform Body" (1994) 2 Waikato Law Review 87.
[287] Loke, above n 61, at 124.
[288] Cichos, above n 212, at 421.

Despite the aforementioned functional equivalence of New Zealand's market fairness regime and the modern fiduciary rationale found in the United States, the latter has its unique theoretical implications. Relevantly, the fiduciary rationale conceives insider trading as a private matter; even the wide-ranging misappropriation theory frames insider trading as a breach of duty as between the insider and their principal. This juxtaposes with the public conception of the financial sector and insider trading in New Zealand under the market fairness regime, and in my view a private conception is incompatible with the moral and economic justifications for insider trading identified in Chapter 2: insider trading is seen as a victimless crime in New Zealand. Accordingly, it would be hollow to justify insider trading prohibition in New Zealand on duties owed to any person or listed issuer by an insider. In principle, an information connection regime best suits the victimless conception of insider trading.[289]

Furthermore, public enforcement of a fiduciary regime sits uncomfortably against the backdrop of the private nature of the rationale.[290] In theory, a breach of fiduciary duty (even liberally interpreted) scarcely justifies public regulatory intervention. It has been suggested that this incongruity of the United States' prohibition is an incident of the statutory regime from which it germinated, and accordingly "if one were to start on a clean slate, it is doubtful whether one would adopt the fiduciary theory as the basis for constructing insider trading liability".[291] This point weighs in favour of the New Zealand market fairness regime.

A further implication of a fiduciary rationale revealed by the United States experience is that courts must be prepared to take a liberal approach to fiduciary theory and precedent if the fiduciary prohibition is to capture a full range of undesirable conduct. Under New Zealand's formal vision of law, I suggest a fiduciary theory would be unworkable; the judiciary's conservative interpretive tradition would struggle to extend the fiduciary theory as far as has occurred in the United States. Therefore, New Zealand's insider trading regime is best conceived as a wide-ranging statutory prohibition (as it is today): this obviates the need for liberal judicial interpretation and achieves the same practical effect as the United States' common law fiduciary prohibition. With the parameters set at their widest by the FMCA, the

[289] Baxt, Black and Hanrahan *Securities and Financial Services Law*, above n 147, at 696.
[290] Dennis W Carlton and Daniel R Fischel "The Regulation of Insider Trading" (May 1983) 35 Stan L Rev 857 at 889.
[291] Loke, above n 61, at 131.

limits of the prohibition are likely to be determined by practicalities of enforcement, rather than judicial interpretation.[292]

Overall, I contend that in a New Zealand context, the market fairness rationale provides a sounder justification for an insider prohibition than fiduciary theory. The statutory fiduciary regime in the SAA was unsuccessful;[293] in my view, its failure was due to its highly prescriptive construction (as necessitated by our legal tradition), which stunted its evolution. Furthermore, a common law fiduciary prohibition would be unworkable within New Zealand's formal constitutional tradition. Accordingly, a statutory market fairness regime effectively captures a full range of undesirable insider conduct without venturing into the difficult doctrinal territory of cases such as *Dorozhko*.

Conclusion on the jurisprudence

The SAA serves as an example of how the fiduciary rationale may manifest itself in prescriptive statutory form. However, the marked evolution of the United States' prohibition suggests a return to an SAA-type regime would be a step backwards for New Zealand law, especially given the modernisation of capital markets since New Zealand first prohibited insider trading in 1988. I argue the SAA regime was unsuccessful[294] in part due to its inability to keep pace with the legal development that was occurring in the United States; however, the current New Zealand regime under the FMCA provides a functional equivalent to the United States' prohibition that is appropriate for the New Zealand context.

As I have demonstrated, the fiduciary and market fairness rationales have quite distinct implications at a theoretical level. Ultimately, however, there is an inevitable degree of overlap: the fiduciary rationale does not preclude notions of market fairness, and the United States' experience demonstrates that a strict approach to the fiduciary rationale leaves holes in the regime, necessitating increasingly liberal interpretation that gives effect to market fairness principles. As such liberal interpretation would be inconsistent with New Zealand's judicial tradition, explicit adoption of a market fairness regime sits neatly within the New Zealand legal system.

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[292] The parameters being set by judicial interpretation in *Chiarella* and *Dirks*.
[293] (14 December 2004) 622 NZPD 18039.
[294] (14 December 2004) 622 NZPD 18039.

Contrary to my initial expectations, I have found that the capture of the United States' fiduciary prohibition is substantially similar to New Zealand's market fairness regime. However, I conclude that the market fairness regime is better suited to the New Zealand vision of law as a matter of practicality and clarity.

Chapter 4: Critique

My foregoing analysis unpacks the New Zealand insider trading regime at the statutory and theoretical level. This Chapter serves to draw these threads together through a general critique.

The statute itself

As found in Chapter 1, the FMCA's construction is, for the most part, appropriate for the New Zealand context. The statute is modelled on the well-established Corporations Act (Cth); however, improvements have been made where the Australian experience has shown necessary. For example, s 232(1)(b) of the FMCA refers to 'readily obtainable' information, following the Australian courts' difficulty interpreting the 'readily observable' definition in the Corporations Act in *Kruse* and *Firns*.[295]

Some minor issues with the FMCA arise. As the FMCA provisions are largely untested in the courts, my analysis of the statute may be unduly critical. However, theoretical inconsistencies such as the superfluity of the reasonable period for dissemination requirement in s 232 reveal areas in which the prohibition's operation might be complicated by interpretive difficulties.

Finally, I consider the insertion of the reasonable person requirement into the definition of materiality in s 231 of the FMCA resolves the difficulties that arose under the definition of materiality in the SAA (as borne out in *Haylock*). However, in my view the provision does not go far enough towards explicitly adopting the "reasonable investor" materiality test found in the United States jurisprudence by the use of a deeming provision identifying the "reasonable person" (as is found in the Australian regime).

The theoretical rationale

[295] *Kruse* and *Firns*, above n 67.

In New Zealand, the market fairness rationale provides a sounder justification for an insider trading prohibition than fiduciary theory. My reasons for this suggestion are threefold.

First, the market fairness regime is consistent with the commonly accepted moral and economic justifications for insider trading regulation. A fiduciary regime would be incongruous with the conception of insider trading as a victimless crime, and the process of establishing a personal connection between an insider and the listed issuer would be somewhat contrived. Furthermore, my research suggests market fairness principles form a subtext to the United States' regime regardless;[296] however, this can be explained by the different legal traditions that characterise the New Zealand and United States legal systems.

Secondly, the market fairness rationale implicitly conceives the market as a matter of public importance. This is congruous with the treatment of the financial sector as a public good in the present day. Furthermore, public enforcement of the prohibition theoretically aligns with this conception; in my view, the private law basis of a fiduciary rationale does not provide a compelling justification for public enforcement.

Finally, a broad prohibition such as s 231 of the FMCA suits New Zealand's formal vision of law. The United States experience demonstrates that, to retain its efficacy, a fiduciary rationale must evolve: I argue New Zealand's constitutional tradition precluded this evolution, as the New Zealand interpretive approach necessitates prescriptive legislation, which inevitably comes at the expense of flexibility. This juxtaposes against the vague United States statutory framework and the substantive interpretive tradition that has let the fiduciary prohibition set out in *Chiarella* evolve into a regime aptly described today as "post-fiduciary".[297] Therefore, I suggest a fiduciary rationale was fundamentally inappropriate for the New Zealand legal system.

Overall, I have formed the view that the market fairness rationale is appropriate for the New Zealand context. This conclusion is contrary to my initial expectations: at the outset of my research, I was of the view that the market fairness rationale was unduly broad. Others may still hold such a view. However, the United States' experience has convinced me that the narrow capture of a fiduciary rationale must broaden to fill the inevitable voids in a

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[296] Cox and Fogarty, above n 284, at 366.
[297] Bainbridge, above n 279.

prohibition predicated on personal connections. A statutory market fairness prohibition achieves the same function, albeit in a manner appropriate to New Zealand's legal system.

Conclusion

When I began this analysis, I felt the market fairness and fiduciary rationales sat at opposite poles. I intended to explore whether it would be sound for New Zealand to return to a fiduciary rationale, as was previously found in the SAA. However, I soon realised this was an unwise line of inquiry. I now take the view that the market fairness rationale underpinning the FMCA regime is appropriate for the formal interpretive tradition of the New Zealand courts. My overall conclusion is that the insider trading prohibition found in the FMCA is internally and theoretically coherent and, accordingly, I conclude that the current insider trading regime is suitable for the New Zealand context and fit for purpose.

This dissertation does not focus on the enforcement efforts undertaken by the NZX and the FMA. However, New Zealand's enforcement record is recognised as comparatively weak.[298] I cannot critique this, not least because the true extent of insider trading in New Zealand is inevitably opaque. I do comment, however, that in the past Australia[299] and the United Kingdom[300] were criticised for weak enforcement; concerted regulatory efforts reversed those criticisms.[301] I recognise a similar effort may be restricted in New Zealand by resource constraints, political appetite or a number of other reasons. However, I conclude that the current insider trading regime is sound in terms of statutory construction and underlying theory; this provides a strong platform for enforcement efforts to proceed from.

Given the relatively recent introduction of the FMCA, it seems unlikely that further securities market regulation reform is on the horizon. Fortunately, then, I have reached a positive conclusion on the regime's suitability to the New Zealand context. However, the 1987 sharemarket crash demonstrates an impetus for change can materialise suddenly. Regardless, I hope this dissertation maps New Zealand's insider trading jurisprudence in a level of detail

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[298] Walker and Simpson, above n 5, at 536.
[299] Michael Ziegelaar "Insider Trading Law in Australia" in Gordon Walker, Brent Fisse and Ian Ramsay (eds) *Securities Regulation in Australia and New Zealand* (2nd ed, LBC, Sydney, 1998) 556 at 591.
[300] Paul Barnes "Insider dealing and market abuse: the UK's record on enforcement" (2011) 39 International Journal of Law, Crime and Justice 174 at 187.
[301] To the extent that Australia's enforcement efforts now rival the United States': see Coffee, above n 173, at 281.

that reflects the growing importance of the capital markets to New Zealanders, especially in the context of the Capital Markets 2029 growth agenda that is currently underway.

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Appendix I: Timeline

1934
- Franklin D Roosevelt's "New Deal" raft of legislation includes the Securities Exchange Act 1934. The Act constitutes the Securities and Exchange Commission ("SEC").

1948
- In the United States, Rule 10b-5 promulgated by the SEC under s 10(b) of the Securities Exchange Act.

1968
- United States Court of Appeals for the Second Circuit interprets Rule 10b-5 as upholding market fairness principles in *SEC v Texas Gulf Sulphur Co*.

1977
- *Coleman v Myers* decided in New Zealand.

1979
- The Securities Commission is established in New Zealand by the Securities Act 1978.

1980
- Australia enacts the Securities Industry Act 1980 (Cth), implementing a fiduciary prohibition at federal level. Previously, insider trading had been regulated at State level, for example by the Securities Industry Act 1970 (NSW).
- The United States Supreme Court adopts a fiduciary rationale in relation to r 10b-5 in *Chiarella v US*.

1983
- The United States Supreme Court extends insider trading liability to "constructive insiders" in *Dirks v SEC*.

1987
- Sharemarket crash on 19th October ("Black Monday") provides impetus for securities reform in New Zealand.

1988
- Securities Amendment Act enacted in New Zealand following recommendation by the Securities Commission. Fiduciary-based prohibition implemented.

1991
- Australia implements a market fairness insider trading regime with the Corporations Legislation Amendment Act 1991, following the recommendations made by the Griffiths and Anisman Committees.

2002
- Securities Amendment Act renamed Securities Markets Act by the Securities Markets Amendment Act 2002.
- Securities Markets Act amended, allowing the Securities Commission to enforce a private right of action for insider trading.

2006
- Securities Markets Amendment Act enacted in New Zealand, implementing a market fairness insider trading regime.

2011
- Financial Markets Authority constituted.

2013
- Financial Markets Conduct Act enacted. An omnibus statute combining a number of statutes, including the Securities Markets Act.

2017
- Jeffrey Honey convicted of insider trading in *FMA v Honey*.

2018
- Hamish Sansom acquitted by a High Court jury in *R v Sansom*.

Appendix II: Relevant provisions from the Financial Markets Conduct Act 2013

Interpretation

6 Interpretation

(1) In this Act, unless the context otherwise requires,—
information includes documents
information insider has the meaning set out in section 234
licensed market means a financial product market that is licensed under Part 5 (subject to any regulations made under section 351(1)(d))
licensed market operator means a person that is authorised to operate a licensed market under a financial product market licence
listed issuer means—

(a) a person that is a party to a listing agreement with a licensed market operator in relation to a licensed market (and includes a licensed market operator that has financial products quoted on its own licensed market):
(b) a person to which paragraph (a) previously applied, in respect of any action or event or circumstance to which this Act applied at that time

listing rules means the rules for a financial product market that deal with the matters set out in section 328(3)(a) to (e)
material information,—

(b) in Part 5, has the meaning set out in section 231

participant means, in relation to a licensed market, a person authorised by the licensed market operator to participate in that market
person includes any entity
quoted, in relation to—

(a) financial products of a listed issuer, means financial products of the issuer that are approved for trading on a licensed market (and, to avoid doubt, financial products do not cease to be quoted merely because trading in those products is suspended):
(b) derivatives, means derivatives that are approved for trading on a licensed market (and, to avoid doubt, derivatives do not cease to be quoted merely because trading in those products is suspended)

underlying, in relation to a derivative, means the underlying asset, rate, index, commodity, or other thing referred to in section 8(4)(a)(iii)

7 Meaning of financial product

(1) In this Act, **financial product** means—

(a) a debt security; or
(b) an equity security; or
(c) a managed investment product; or
(d) a derivative.

(2) If an interest or a right is declared by regulations not to be a security for the purposes of this Act, the interest or right is not a financial product for the purposes of this Act.

Part 5

Dealing in financial products on markets

Subpart 1—Purposes, overview, and interpretation

229 Additional purposes of Part

(1) This Part has the following purposes for financial product markets (in addition to those set out in sections 3 and 4):

(a) to promote fair, orderly, and transparent financial product markets:

(b) to encourage a diversity of financial product markets to take account of the differing needs and objectives of issuers and investors.

(2) This section does not limit section 3 or 4.

Material information and generally available to the market

231 Meaning of material information

(1) In this Part, **material information**, in relation to a listed issuer, is information that—

(a) a reasonable person would expect, if it were generally available to the market, to have a material effect on the price of quoted financial products of the listed issuer; and

(b) relates to particular financial products, a particular listed issuer, or particular listed issuers, rather than to financial products generally or listed issuers generally.

(2) In this Part, **material information**, in relation to quoted derivatives, the underlying of quoted derivatives, or the issuer of a financial product underlying quoted derivatives, is information that—

(a) a reasonable person would expect, if it were generally available to the market, to have a material effect on the price of the derivatives; and

(b) relates to particular derivatives, a particular underlying, or a particular issuer of a financial product underlying quoted derivatives, rather than to derivatives generally or underlyings generally or issuers generally.

232 Meaning of generally available to the market

(1) In this Part, information is **generally available to the market**—

(a) if—

(i) it is information that has been made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in relevant financial products; and

(ii) since it was made known, a reasonable period for it to be disseminated among those persons has expired; or

(b) if it is likely that persons who commonly invest in relevant financial products can readily obtain the information (whether by observation, use of expertise, purchase from other persons, or any other means); or

(c) if it is information that consists of deductions, conclusions, or inferences made or drawn from either or both of the kinds of information referred to in paragraphs (a) and (b).
(2) In this section, **relevant financial products** means financial products of a kind the price of which might reasonably be expected to be affected by the information.
(3) Information that is notified in accordance with a continuous disclosure obligation is generally available to the market under subsection (1)(a) immediately on it being made available to participants in a licensed market (without limiting how quickly the reasonable period of dissemination in subsection (1)(a)(ii) may be satisfied in other cases).

Insider conduct

234 Meaning of information insider, inside information, and adviser

(1) In this Part, a person is an **information insider** of a listed issuer if that person—
(a) has material information relating to the listed issuer that is not generally available to the market; and
(b) knows or ought reasonably to know that the information is material information; and
(c) knows or ought reasonably to know that the information is not generally available to the market.
(2) A listed issuer may be an information insider of itself.
(3) In this Part, a person is an **information insider** in relation to quoted derivatives if that person—
(a) has material information relating to any of the following that is not generally available to the market:
(i) the derivatives:
(ii) the underlying:
(iii) the issuer of a financial product underlying the derivatives; and
(b) knows or ought reasonably to know that the information is material information; and
(c) knows or ought reasonably to know that the information is not generally available to the market.
(4) In this Part, **inside information** means—
(a) the information in respect of which a person is an information insider of the listed issuer in question; or
(b) in the case of quoted derivatives, the information in respect of which a person is an information insider in relation to the derivatives in question.
(5) In this Part, **adviser** means an adviser acting in a professional capacity (for example, a lawyer, an accountant, or a financial adviser).

Subpart 2—Insider trading

Insider conduct prohibited

240 Prohibition on insider conduct

(1) A person must not do any of the things set out in any of sections 241(1), 242(1), and 243(1) if the person is an information insider of the listed issuer.
(2) A person must not do any of the things set out in any of sections 241(2), 242(2), and 243(2) if the person is an information insider in relation to quoted derivatives.

241 Information insider must not trade

(1) An information insider of a listed issuer must not trade quoted financial products of the listed issuer.
(2) An information insider in relation to quoted derivatives must not trade the derivatives.
(3) In this subpart and subpart 3, **trade**—
(a) means acquire or dispose of; but
(b) does not include acquire, or dispose of, by inheritance or gift.

242 Information insider must not disclose inside information

(1) An information insider (**A**) of a listed issuer must not directly or indirectly disclose inside information to another person (**B**) if A knows or ought reasonably to know or believes that B will, or is likely to,—
(a) trade quoted financial products of the listed issuer; or
(b) advise or encourage another person (**C**) to trade or hold those products.
(2) An information insider (**A**) in relation to quoted derivatives must not directly or indirectly disclose inside information to another person (**B**) if A knows or ought reasonably to know or believes that B will, or is likely to,—
(a) trade the derivatives; or
(b) advise or encourage another person (**C**) to trade or hold those derivatives.

243 Information insider must not advise or encourage trading

(1) An information insider (**A**) of a listed issuer must not—
(a) advise or encourage another person (**B**) to trade or hold quoted financial products of the listed issuer:
(b) advise or encourage B to advise or encourage another person (**C**) to trade or hold those financial products.
(2) An information insider (**A**) in relation to quoted derivatives must not—
(a) advise or encourage another person (**B**) to trade or hold the derivatives:
(b) advise or encourage B to advise or encourage another person (**C**) to trade or hold those derivatives.

244 Criminal liability for insider conduct

(1) A person who contravenes any of sections 241 to 243 commits an offence if the person knows—
(a) that the information is material information; and
(b) that the information is not generally available to the market; and
(c) in the case of a contravention of section 242, of any of the matters set out in section 242(1)(a) or (b) or (2)(a) or (b).
(2) A person who commits an offence under subsection (1) is liable on conviction,—
(a) in the case of an individual, to imprisonment for a term not exceeding 5 years, a fine not exceeding $500,000, or both; and
(b) in any other case, to a fine not exceeding $2.5 million.

When prohibition on insider conduct does not apply

245 Exception for trading required by enactment or rule of law

Section 241 does not apply to trading in financial products that is required by an enactment or any rule of law.

246 Exception for disclosure required by enactment or rule of law or by FMA

Section 242 does not apply to disclosure that is required by—

(a) an enactment or any rule of law; or

(b) the FMA when exercising a power under this Act or any other enactment.

247 Exception for disclosure in connection with preparing PDS or limited disclosure document

Section 242 does not apply to disclosure that is necessary, in connection with an offer of financial products for sale, in order to assist in the preparation of a PDS, a register entry, or a limited disclosure document for that offer.

248 Exceptions in respect of underwriting agreements

(1) Section 241 does not apply to the acquisition of the financial products of a listed issuer under an underwriting or a sub-underwriting agreement.
(2) Section 242 does not apply if the inside information is disclosed to a person for the sole purpose of negotiating an underwriting or a sub-underwriting agreement with that person in respect of the financial products in question.
(3) Section 243 does not apply if the advice or encouragement is given for the sole purpose of persuading the person to whom it is given to enter into an underwriting or a sub-underwriting agreement in respect of the financial products in question.

249 Exceptions in case of knowledge of person's own intentions or activities

(1) A person (**A**) does not contravene section 241(1) merely because A trades the financial products with the knowledge that A proposes to enter into, or has previously entered into, 1 or more transactions or agreements in relation to the financial products or the listed issuer or the listed issuer's business activities.
(2) A person (**B**) does not contravene section 243(1) merely because B advises or encourages another person (**A**) to trade or hold financial products when B has knowledge, acquired in the course of acting as A's adviser, that A proposes to enter into, or has previously entered into, 1 or more transactions or agreements in relation to the financial products or the listed issuer or the listed issuer's business activities.

250 Exceptions in case of knowledge in relation to derivatives

(1) A person (**A**) does not contravene section 241(2) merely because A trades in derivatives with knowledge of A's own past, current, or proposed—

(a) transactions or agreements concerning those or any other derivatives; or

(b) business activities, transactions, or agreements concerning the underlying.

(2) If a person (**B**) advises or encourages another person (**A**) to trade or hold derivatives, B does not contravene section 243(2) merely because B has knowledge, acquired in the course of acting as A's adviser, of A's past, current, or proposed—

(a) transactions or agreements concerning derivatives; or

(b) business activities, transactions, or agreements concerning the underlying.

251 Exception for agent executing trading instruction only

Section 241 does not apply in the case of a person (**A**) if,—

(a) in trading the financial products, A was acting on behalf of another person (**B**); and

(b) A traded the financial products on B's specific instruction; and

(c) before trading, A did not disclose inside information to B; and

(d) A did not advise or encourage B to instruct A to trade.

252 Exceptions from section 241 for takeovers

(1) Section 241 does not apply to—

(a) trading that results from a takeover offer under the Takeovers Code; or

(b) entering into an agreement to acquire or dispose of financial products at a fixed price under a future takeover offer that complies with the Takeovers Code; or

(c) the acquisition or disposal of financial products in performance of an agreement to acquire or dispose of those financial products at a fixed price under a future takeover offer that complies with the Takeovers Code.

(2) For the purposes of this section and section 253, if an exemption has been granted under section 45 of the Takeovers Act 1993 in relation to a takeover offer and the offer is made in accordance with the terms and conditions of the exemption and the applicable provisions of the Takeovers Code from which there is no exemption, the offer must be taken to—

(a) be a takeover offer under the Takeovers Code; and

(b) comply with the Takeovers Code.

253 Exceptions from sections 242 and 243 for takeovers

(1) Section 242 does not apply to the following conduct:

(a) disclosure of inside information to a prospective offeror or its advisers under a prospective takeover offer under the Takeovers Code:

(b) disclosure of inside information to encourage competing bona fide offers to be made in competition with a takeover offer under the Takeovers Code:

(c) disclosure of inside information by a prospective offeror or its advisers under a prospective takeover offer under the Takeovers Code for the purpose of forming a consortium to make a takeover offer:

(d) disclosure of inside information to an independent adviser to enable that adviser to make a report required by the Takeovers Code.

(2) A person's reliance on subsection (1)(a) to (c) is subject to the conditions that—

(a) the recipient of the information is bound by an obligation of confidentiality in respect of the information; and

(b) the purpose of the conduct is to enable or encourage the recipient to make a takeover offer or to participate in a takeover offer.

(3) Section 243 does not apply to advice or encouragement given—

(a) by the directors of a company that is the target company under a takeover offer under the Takeovers Code, to the extent that the advice or encouragement is given to the company's shareholders and relates to those shareholders trading or holding their financial products; or

(b) by a prospective offeror under a prospective takeover offer under the Takeovers Code for the purpose of forming a consortium to make a takeover offer.

(4) A person (**A**) does not contravene section 242 or 243 merely because A, in relation to a takeover offer or prospective takeover offer under the Takeovers Code, discloses inside information to another person (**B**) or advises B to trade or hold financial products of the listed issuer when A has that inside information, or is an information insider, only through acting as B's adviser in relation to the takeover offer or prospective takeover offer.

254 Exceptions for schemes of arrangement approved under Companies Act 1993

(1) Section 241 does not apply to trading that results from an arrangement approved under Part 15 of the Companies Act 1993.

(2) Section 243 does not apply to advice or encouragement by the directors of a company that is the subject of an arrangement approved, or a proposed arrangement to be approved, under Part 15 of the Companies Act 1993, to the extent that the advice or encouragement is given to the company's shareholders and relates to those shareholders trading or holding their shares.

255 Exception for redemption of managed investment products

Section 241 does not apply to the redemption of managed investment products in a managed investment scheme if the redemption price is calculated by reference to the underlying value of the assets of the scheme.

256 Exception for Reserve Bank

Section 241 does not apply to trading by the Reserve Bank in financial products issued by the Reserve Bank or by the Crown.

Defences

257 Absence of knowledge of trading

In any proceeding against a person (**A**) for contravention of section 241, it is a defence if A did not know, and could not reasonably be expected to know, that A traded the financial products.

258 Inside information obtained by independent research and analysis

(1) In any proceeding against a person (**A**) for contravention of section 241 or 242, it is a defence if the inside information was obtained by research and analysis and was not obtained directly or indirectly from the listed issuer concerned.

(2) In any proceeding against a person (**A**) for contravention of section 243, it is a defence if A encouraged or advised on the basis of inside information that was obtained by research and analysis and that was not obtained directly or indirectly from the listed issuer concerned.

(3) In subsections (1) and (2), **research** means planned investigation undertaken to gain new knowledge and understanding.

259 Equal information

(1) In any proceeding against a person (**A**) for contravention of section 241, it is a defence if the opposite party to the transaction knew, or ought reasonably to have known, the same inside information as A before the transaction took place.
(2) In any proceeding against a person (**A**) for contravention of section 242, it is a defence if the person to whom the information is disclosed knew, or ought reasonably to have known, the same inside information as A before it was disclosed.
(3) In any proceeding against a person (**A**) for contravening section 242 or 243 by disclosing inside information to another person (**B**) or by advising or encouraging B to trade or hold quoted financial products, it is a defence if A has that inside information, or is an information insider, only through acting as B's adviser in relation to trading or holding those financial products.

260 Options and trading plans

(1) In any proceeding against a person (**A**) for contravention of section 241, it is a defence if—
 (a) A traded the financial products under a fixed trading plan or under options with a fixed exercise price; and
 (b) A entered into the trading plan, or acquired the options, as the case may be,—
  (i) before A obtained the inside information; and
  (ii) without any intent to evade section 241.
(2) A **fixed trading plan** is a trading plan—
 (a) that—
  (i) is fixed for a period of time; and
  (ii) gives the investor no right to withdraw before the end of that period; and
  (iii) is not subject to any influence by the investor as to trading decisions after the plan has begun; or
 (b) that is an employee share purchase scheme that comes within paragraph (a) except that the plan may be earlier terminated, and the investor may withdraw, on the termination of the investor's employment or appointment.

261 Chinese wall defence

(1) In any proceeding against a person (**A**) for contravention of section 241 or 243, it is a defence if—
 (a) A had in place arrangements that could reasonably be expected to ensure that no individual who took part in the decision to trade the financial products or to advise or encourage (as the case may be) received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information; and
 (b) no individual who took part in that decision received, or had access to, the inside information or was influenced, in relation to that decision, by an individual who had the information; and
 (c) every individual who had the information and every individual who took part in that decision acted in accordance with the arrangements referred to in paragraph (a).
(2) In any proceeding against a person (**A**) for disclosing information to another person (**B**) in contravention of section 242, it is a defence if A believed on reasonable grounds that B had in place arrangements that could reasonably be expected to ensure that no individual who would take part in the decision to trade the financial products or to advise or encourage (as the case may be) would

receive, or have access to, the inside information or would be influenced, in relation to that decision, by an individual who had the information.