MATERIALITY IN INSIDER TRADING: An obstacle to enforcement and compliance.

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INTRODUCTION

Materiality is a murky concept.[1] It has been labelled a "workhorse" to be mastered by the practitioner and is commonly known as an "ulcerating experience".[2] It has also been labelled a "gotcha" standard because it is often seen to be determinable only ex post facto.[3] Materiality plays an important gatekeeper role in the area of financial disclosure[4] and insider trading. Unfortunately despite its importance in sorting legitimate trading from insider trading it is arguably an unobservable threshold that relies entirely on the hindsight of the courts.

The recent litigation in Australia involving Citigroup Global Markets highlighted the considerable difficulty of materiality determinations in a market fairness insider trading regime. In *Citigroup*[5] Mr Manchee, an employee of Citigroup's "public side", bought and sold shares in a company ("Patrick") that was the target of a takeover attempt. Unknown to Manchee, Citigroup's "private side" was advising Toll (the acquirer).

At the time of Manchee's sale, the market had already moved the share price to a level that reflected "the substantial likelihood" of a takeover. The further non-public information that Manchee held, that Citigroup was acting for the bidder, was not material. However the Court went on to analyse the materiality of the information held by senior Citigroup officers; knowledge of the timing of the announcement of the takeover bid. The Court's materiality analysis of this information reflected a pure market impact test. Before the start of trading on Monday, the takeover was announced to the market. The Court found knowledge of the timing of the release was material because the Patrick shares opened the day of the announcement at $7.19, 10.9% higher than the closing price the Friday before. In the Court's view this established the materiality of the information.

The Court's approach highlights the difficulty in applying the materiality test. The price movement between the close of trading on the Friday and the open of trading on Monday after the announcement could have been attributed to a number of factors. Perhaps the speculation in

[1] Glenn F Miller, 'Comment, Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality' (2000) 361 *Northwestern University Law Review* 389 at 363.
[2] Yvonne Ching Ling Lee, 'The Elusive Concept of Materiality under U.S. Federal Securities Laws' (2004) 40 *Willamette Law Review* 661 at 664.
[3] Ibid.
[4] Miller, above n 1, at 368.
[5] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.

the market that existed on Friday had convinced investors over the weekend to buy shares at the open of trading on Monday. Or perhaps the 10.9% rise was in part the markets response to the announcement itself, not purely knowledge of the timing of the announcement. On Sunday, none of the insiders could have known the exact extent of the reaction of the market. Knowledge of the timing of the announcement is of little value to an inside trader without the accompanying knowledge of the likely direction and extent of the reaction of the market.

This research will focus on the new definition of "material information"[6] and investigate how the change in the underlying rationale for regulating insider trading might affect this element of insider trading. An attempt will be made to elucidate the threshold for materiality based on the decided cases in New Zealand, Australia, and the United States (US).

Despite the debate about the merits of regulating insider trading[7] for the purposes of this research it is conceded that some form of insider trading regulation is desirable. Chapter one will set out the new insider trading sections and put the materiality test in its context. Chapter two will analyse what effect the underlying rationale for insider trading sections has on the approach to material information. The heavily "fiduciary" based justification in the US provides a contrast to the new "market fairness" approach of the Securities Markets Amendment Act 2006 ("SMAA"). In Chapter three the effect of the materiality test and the ambiguity that accompanies it will be examined from a regulatory point of view.

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[6] Securities Markets Amendment Act 2006 ("SMAA") section 4: "For the purposes of this Act, unless the context otherwise requires, material information, in relation to a public issuer but not in relation to a futures contract referred to in section 3A, 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 listed securities of the public issuer; and
(b) relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.

[7] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at paragraph 4.6.2, some theories argue insider trading increases the efficiency of the share price because it promotes a market response to developments earlier than without the trading; at paragraph 4.6.6., others have argued it provides an appropriate reward for entrepreneurs.

CHAPTER ONE
THE NEW INSIDER TRADING FRAMEWORK

A. THE CHANGE FROM A FIDUCIARY RATIONALE TO A MARKET FAIRNESS RATIONALE

The explanatory note to the Securities Legislation Bill 2006 ("the Bill") proposed that the Bill would strengthen the law relating to insider trading by adopting a regime that is focussed on upholding market integrity and confidence of the investing public as opposed to a breach of a duty owed to the company.[8] The SMAA removes the requirement that an "insider" be connected to the company.[9] An insider is defined solely by possession of inside information. The definition of "inside information" is similar to what it was under the Securities Markets Act 1989 ("SMA"). The information must be "material information"[10] that is "not generally available".[11] In the absence of a connection to the company, the material and non public qualities assume increased significance.

A fiduciary rationale aims to increase confidence in the market by removing the unfair advantage insiders have because of access to confidential and potentially significant information. It recognises the insiders' duties not to take advantage of their position by using information for personal gain. It also recognises the ultimate duty of loyalty that an insider owes to the company and shareholders not to be in a position of conflict with the company's interests.

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[8] Explanatory Note, *Securities Legislation Bill* (2006).

[9] Section 3 Securities Markets Act 1988 (SMA) defines an insider as:
a) the public issuer; or
b) a principle officer, employee or company secretary who has information by virtue of their position; or
c) a tippee who receives information in confidence from a principle officer, employee or company secretary; or
d) a tippee of the first tippee.

[10] SMA section 2, information which "would or would be likely to, affect materially the price of the securities of the public issuer if it were generally available"; and is defined under the SMAA as (a) a reasonable person would expect, if it were generally available to the market, to have a *material effect* on the price of listed securities of the public issuer; and (b) relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.

[11] This was defined under the SMA in section 2 as information "not publicly available" and is now defined under the SMAA as information "not generally available" section 4(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 securities; 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 securities 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).

A market fairness rationale aims to increase confidence in the market by penalising unfair advantage gained by *any person* in the market through access to potentially significant information.[12] It recognises that outsiders can do as much damage to the confidence in the market if they unfairly use an informational advantage to profit.

[12] "The main purpose for the insider trading provisions is to ensure that the securities market operates freely and fairly so that one party to a transaction does not, because of the possession of asymmetric information, have an advantage over the other party" *ASIC v Petsas & Miot* [2005] FCA 88; [2005] 23 ACLC 269 at 11, Finklestein J.

B. THE SECURITIES MARKETS AMENDMENT ACT 2006: THE MECHANICS OF A MARKET FAIRNESS REGIME

Under the SMAA there are 5 elements to insider trading:

- There needs to be in existence some material information;[13]
- The information must not be generally available;[14]
- A person[15] must have possession of the information;[16]
- A person must know, or ought to reasonably know,[17] that the information is material and not generally available.

Once these elements have been satisfied the person is an "information insider" of the public issuer[18] who possesses "inside information"[19] and must not: trade in the shares of the issuer;[20] disclose the information to anyone where they might act on the information;[21] or advise or discourage trading in the shares of the issuer.[22]

1. *The definition of "information"*

Information is not defined under the SMAA.[23] A definition is important because an assessment of materiality can ultimately depend on the substantive content of the information possessed by a person.[24] In Australia, information can be as broad as an "un-communicated supposition"[25] and need not be specific.[26] In *Hooker,*[27] Young J held that information included "factual knowledge of

[13] SMAA s 8A(1)(a).
[14] SMAA s 8A(1)(a).
[15] SMAA s 8A(1), or company by virtue of its officers.
[16] SMAA s 8A(1), the section reads: "A person is an information insider... if that person- has material information..."
[17] SMAA s 8A(1)(b)(c).
[18] SMAA s 8A.
[19] SMAA s 8B.
[20] SMAA s 8C.
[21] SMAA s 8D.
[22] SMAA s 8E.
[23] Nor was it defined in previous insider trading legislation in New Zealand.
[24] This was an issue in *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373, where an argument of unfairness was raised because the prosecution did not limit itself to arguing the materiality of the information particularised, that the Hannes knew that a takeover would likely be made at a price above $2.01, rather suggested that Hannes knew the precise range for a takeover was between $2.40 and $2.50. As this information was more specific it was argued it would be easier to establish materiality.
[25] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963, at paragraph 542. The "hint or other non-specific information must be communicated by words or conduct, the inference or supposition to be drawn from it is "information" within the statutory definition."
[26] The effect of *Ryan v Triguboff* [1976] 1 NSWLR 588, that information needed to be concrete and specific was overruled by an amendment to the Corporations Act 2001 section 1042A that defined information as "Matters of supposition and other matters that are insufficiently definite to warrant being made known to the public; and (b) matters relating to the intentions or likely intentions of a person"; *Ampolex Ltd v Perpetual Trustee Trading Co (Canberra)*

a concrete kind or that obtained by means of a hint or veiled suggestion from which one can impute other knowledge”,[28] including “a rumour that something has happened with respect to a company which a person neither believes nor disbelieves”.[29]

Furthermore, courts in New Zealand and Australia do not explicitly categorise different types of information like the US courts.[30] The different types of information: hard, soft, forward looking, and backward looking,[31] complicate materiality assessments.

Reliability is one of the main factors an investor takes into account when deciding whether to act on information.[32] Hard information is information about the past or present. It can be verified by objective facts in the past or present, therefore has a high degree of reliability.[33] Conversely, soft information is defined by the fact it cannot be verified by objective facts.[34] It may contain an element of opinion or judgement, or may be information about something unquantifiable.[35] Soft information contains a much lower degree of verifiability, and therefore reliability.

Ltd (1996) 20 ACSR 649 at 658; and *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 confirm this view; Cf the UK approach: “Insider trading under the FSMA turns less on how the trader comes into possession of confidential information; one’s ability to deal with the information is determined principally by the nature of the information. It must be information of a precise nature that is not generally available” Alexander F Loke, 'From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore' (2006) 54 *American Journal of Comparative Law* 123 at 147; “To be precise, the information must be “specific enough to enable a conclusion to be drawn as to the possible effect of [the information] on the price of qualifying investment” at 148.

[27] *Hooker Investments Pty Ltd v Baring Brothers Halkerston Securities Ltd* (1986) 10 ACLR 462 463.

[28] *Hooker Investments Pty Ltd v Baring Brothers Halkerston Securities Ltd* (1986) 10 ACLR 462 463.

[29] *Hooker Investments Pty Ltd v Baring Brothers Halkerston Securities Ltd* (1986) 10 ACLR 462 463.

[30] For instance in *Basic Inc v Levinson* (1988) 485 US 224 the Supreme Court adopted the test for “material information” in the context of merger negotiations. However the Supreme Court limited the application of this test to the facts stating at 984: “We do not address here any other kinds of contingent or speculative information, such as earnings forecasts or projections.”

[31] Some authors equate forward looking information with soft information but it should be noted that information can have a “soft” quality and not necessarily be forward looking or vice versa.

[32] In *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 51, evidence was admitted about the factors that affect an investor’s decision. Graham Sellars-Jones, an experienced stock broker said an aspect of importance was its source as a judgment had to be made as to its reliability; at paragraph 52, “He pointed out there was a sliding scale of reliability, depending on how certain the person was as to its truth or untruth.”; at paragraph 73 the Crown also called Nigel Littlewood as an expert who acknowledged that “if he (McGowan) had been the source it was relatively authoritative and would have been taken more seriously.”

[33] See *Re Bank of New Zealand: Kincaid v Capital Market Equities Limited* (1995) 7 NZCLC 260,718 the fact the annual report had utilised a new method of reporting insurance benefits led to a 55 million dollar overstatement in the annual profit is an objectively verifiable fact.

[34] Ahal Besorai, 'The Insider and Tentative Information' in Barry Alexander K. Rider and Michael. Ashe (eds), *The Fiduciary, the Insider, and the Conflict: a compendium of essays* (1995) at 244.

[35] Jude Sullivan, 'Materiality of Predictive Information after Basic: A Proposed Two-Part Test of Materiality' (1990) *University of Illinois Law Review* 207 at 207, statements of past or present situations when the maker of the statement lacks the data necessary to prove its accuracy, information based primarily on subjective evaluations, statements involving qualifying words for which there are no generally accepted objective standards of measurement; Victor Brudney, 'A Note on Materiality and Soft Information under the Federal Securities Laws' (1989) 75 *Virginia Law Review* 723 at 723, “information that offers estimates of the present value of illiquid assets”; and at 724 similar to this is information concerning management’s plans and projects for the future, where the execution lies within

Soft information often becomes an issue in the area of positive company disclosures. Some authors suggest a different materiality test should be adopted for positive disclosure as opposed to insider trading because of the different context the information arises.[36] However the US uses the same test for materiality in disclosure and insider trading.[37] In New Zealand the continuous disclosure and insider trading regimes use an identical materiality test. Therefore the problems of soft information apply equally to determining whether to refrain from trading.[38]

Brudney points out that, although it may be less reliable, forward looking predictive information probably holds the most utility for investors.[39] For a person looking for a sound investment, predictions about the future profitability and opportunities for the company are more relevant than past performance[40] (therefore more likely to be material than backwards looking information). This highlights the second important feature of information that contributes to materiality: significance.[41] From this analysis two features of information may affect materiality; its reliability and its significance.

Another major distinction is made between qualitative information and quantitative information.[42] Quantitative information has a direct quantifiable effect on the financial position of the company. Qualitative information does not necessarily have such an effect. In the US it has been recognised that qualitative information might be relevant to investors.[43] New Zealand

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management discretion; Besorai, above n 34, at 244, "Tentative Information need not necessarily relate to expectations regarding the future but may include any statement that cannot be factually supported, whether due to a lack of substantiating data or because the information consists primarily of objective evaluations or opinions"; Besorai, above n 34, at 244, "Any information the verification of which is not objectively ascertainable, falls under this category".

[36] Besorai, above n 34, at 244.

[37] *TSC Industries v Northway Inc* (1976) 426 US 438,449 has been applied in both disclosure context and insider trading.

[38] SMA section 19E, and NZX listing rule 10.1.1.

[39] Besorai, above n 34, at 245; It is significant because it relieves the investor of the need to rely on his or her own inferences about the future from underlying data that is publicly available. Brudney, above n 35 at 723.

[40] Besorai, above n 34, at 245; Bodie, Zvi, Kane, Alex and Marcus, Alan J, *Investments* (Sixth edition, 2005) at 607; the market price of a stock reflects the present value of its expected *future* cash flows and the market price of a stock often does not match the book value of a firm (or the share value using book values)

[41] Emerging Markets Committee of the International Organisation of Securities Commissions, *Insider Trading: How Jurisdictions Regulate It* (2003) at 3, states that in most countries materiality is defined by reference to three factors: the importance of the information; the scope of the information; and the source of the information. The" importance factor" encompasses either the measurement of materiality based on price movement, or the effect on an investor's decision.

[42] John M Fedders, 'Qualitative Materiality: The Birth, Struggles, and Demise of an Unworkable Standard' (1998-1999) 48 *Catholic University Law Review* 41 at 41; Miller, above n 1, at 389; Lee, above n 2, 661.

[43] Fedders, above n 42, at 41.

law clearly indicates information must be the type that would affect the price of the securities, therefore must probably be quantitative.[44]

2. *Possession of inside information*

Information can be possessed in a number of ways. For example, in a tangible physical sense with no knowledge of the content,[45] an intermediate physical sense[46](possessing the means to access the information), or a non-tangible, non-physical sense[47](pure knowledge of the information). *Wilson Neill*[48] determined that possession is objectively determined and there is no requirement for 'subjective knowledge' otherwise the SMA's purpose could be thwarted by issues of proof. It was not accepted that the directors did not possess the information contained in board papers because they had not done an analysis of these papers.[49] Subsequently, the Securities Commission (the "Commission") in its Regal Salmon Report[50] questioned whether the principle in *Wilson Neill* treats a person a person as having inside information when it does not appear from the face of the matters available, but could only be obtained by skilled analysis of the records.[51] The Commission thought the principle did not extend this far and held such a circumstance "would be different from a case where information was available to the director but he/she had not turned his/her mind to it".[52] This suggests unanalyzed data in its raw state is not information until it has been interpreted in a way that reveals its significance.

This possession element must be qualified with the requirement in the SMAA that the trader "knows or ought to know" the information is material and non-public.[53] Objective physical possession is not enough; the person must have awareness or knowledge of the information. This is in line with a market fairness approach as a person cannot damage the integrity of the market if they have no awareness of the information.

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[44] SMAA section 3.
[45] Juliette Overland, 'There Was Movement at the Station for the Word Had Passed Around: How Does a Company Possess inside Information under Australian Insider Trading Laws' (2006) 3 *Macquarie Journal of Business Law* 241 at 245.
[46] Ibid.
[47] Ibid.
[48] *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152.
[49] Wilson Neill 2 NZLR 152 at 161.
[50] Securities Commission, *Report of an Enquiry into Aspects of the Affairs of Regal Salmon Limited Including Trading in Its Listed Securities* (July 1994).
[51] Securities Commission, *Regal Salmon Report,* above n 50, paragraph 18.26.
[52] Securities Commission, *Regal Salmon Report,* above n 50, at paragraph 18.27, the Securities Commission's concluded that the director, Shagin, believed the report to be a true and fair account therefore he did not possess inside information.
[53] SMAA section 8A(1)(b); Overland, above n 45, at 249.

In Australia it has been pointed out there is no requirement that the trader believe the information to be true.[54] This question is distinct from the question of whether the person knew or ought to have known the information was material. The question of whether a *reasonable person* would have believed the information or would have acted on it will be directly relevant to the question of the reliability, therefore materiality.[55] Therefore in the case of soft information, such as a casual comment by a director outlining the director's prediction that the company will exceed its forecasted profit, the person need not believe that the company will exceed its forecasted profit.[56]

3. *Information that is not generally available*

Under the SMAA, information that is generally available is defined as:[57]

1. 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 securities; and[58]
2. Since it was made known, a reasonable period for it to be disseminated among those persons has expired;[59] or
3. It is likely that persons who commonly invest in relevant securities can readily obtain the information (whether by observation, use of expertise, purchase from other persons, or any other means);[60] or

[54] Juliette Overland, 'The Future of Insider Trading in Australia: What Did Rene Rivkin Teach Us' (2005) 10 *Deakin Law Review* 708 at 715: "A person should not need to have knowledge or a belief in the truth of information they possess before they are caught by the prohibition on insider trading. It should be enough that the person merely possessed the information. If knowledge as to the truth of information was required, rumours and gossip would almost never amount to "information". Insiders trading on the basis of a rumour would merely need to argue that they did not necessarily know whether...the rumour was true, only that they heard and acted upon it, in order to escape liability."

[55] *Regina v Rivkin* [2003] NSWSC 447.

[56] Rather it will be asked, would the reasonable person think such a comment was reliable enough that people will act on it causing the share price to rise? This was directly at issue in *Regina v Rivkin* [2003] NSWSC 447 see below chapter 2.

[57] SMAA section 4 replaces the requirement of the SMA that inside information must not be "publicly available". Although the above definition has been substantially adopted from the Australian legislation, there has been one significant change. Instead of using the Australian test "readily observable" the SMAA uses the words "readily obtainable"; Roger Partridge, 'Insider Trading Reform' (September 2006) *New Zealand Law Journal* 311 at 312, this change is a response to the confusion caused by the readily observable test in Australia; See *R v Kruse* (unreported, District Court of New South Wales, O'Reilly J, No 98/11/0908, 2 December 1999; *R v Firns* (unreported, District Court of New South Wales, Sides J, No 98/11/0895, 4 November 1999; (2001) 51 NSWLR 548; [2001] NSWCCA 191.

[58] SMAA section 4(1)(a)(i).

[59] SMAA section 4(1)(a)(ii).

[60] SMAA section 4(1)(b).

4. 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).[61]

In most cases general availability of information and materiality will be mutually exclusive. According to efficient market theory if information is generally available it will already be compounded into the share price,[62] leaving no room for materiality. It is important to recognise that an information insider must have some objective signals to be able to recognise information is both material and generally available.

[61] SMAA section 4(2).
[62] Bodie, Kane, and Marcus, above n 40, at 371.

C. MATERIAL INFORMATION UNDER THE SMAA

Material information is defined in the SMAA as information that:

1. A reasonable person would expect, if it were generally available to the market, to have a *material effect* on the price of listed securities of the public issuer;[63] and
2. Relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.[64]

1. *Who is a "reasonable person"?*

Because the test for materiality is defined by reference to the expectations of a "reasonable person" it is important to determine who the reasonable person is. Although the SMAA's definition of materiality above matches the first limb of the Australian definition of inside information,[65] the Australian law goes on to explain when a reasonable person would take information to have a "material effect" in 1042D.[66] The Australian section sets out the test for materiality as a reasonable investor test. The absence of this second limb of the Australian test in the SMAA increases the significance of the words "reasonable person". Gregory Lyon suggests the words "reasonable person" in the Australian section simply mandate that an objective assessment is made.[67] However, it could be argued the reference to "reasonable person" imports the reasonable investor test into the SMAA. Roger Partridge argues the reasonable investor test was removed because it detracted from the "price sensitivity of the information and was inconsistent with the rationale for the prohibition on insider trading."[68] However, because the insider trading prohibition now extends to all participants, including the unsophisticated investor, it is unclear whether the "reasonable person" means the "reasonable expert"[69] or the average person without expertise in the movements of share prices.[70]

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[63] SMAA section 3(a).

[64] SMAA section 3(b).

[65] Corporations Act 2001 section 1042A.

[66] Corporations Act 2001 section 1042D, when a reasonable person would take information to have a material effect on price or value of (securities): For the purposes of this Division, a reasonable person would be taken to expect information to have a *material effect* on the price or value of particular (securities) if (and only if) the information would, or would be likely to, influence persons who commonly acquire (securities) in deciding whether or not to acquire or dispose of the first mentioned (securities); the "reasonable investor" test**.**

[67] "The phrase 'reasonable person would be taken to expect' requires an objective assessment of the materiality of the information. This part of the provision does not refer to the insider's expectation of that information." Gregory J Lyon, and Jean J du Plessis, *The Law of Insider Trading in Australia* (2005) at 25.

[68] Partridge, above n 57, at 311.

[69] Partridge, above n 57, at 311.

[70] In almost all insider trading cases expert evidence is necessary to establish that the information would be likely to have a material effect. There is often dispute amongst the experts about this see *Re Bank of New Zealand: Kincaid v*

The "reasonable person" was discussed in the context of the continuous disclosure regime[71] in *Auckland International Airport Ltd v Air New Zealand Ltd*.[72] Harrison J held that the adjective "reasonable" is designed to introduce an objective quality.[73] The case equated the "reasonable person" with a sophisticated market participant that "is familiar with the purpose and scope of the continuous disclosure regime, the market within which it operates, the statutory consultative process and the publicly known circumstances of Air New Zealand and AIAL".[74] Harrison J was influenced by the NZX Guidance Note that frames the goals of the continuous disclosure regime in terms of assisting investors to make informed investment decisions.[75] Because the continuous disclosure requirement only applies to listed companies, it is relatively safe to equate the persons making disclosure decisions with a "sophisticated investor". However because the equivalent insider trading test applies to all people in the market it may be inappropriate to read in such qualities into the "reasonable person".[76]

2. *What constitutes a "material effect" on the price of securities?*

Many insider trading regimes contain a requirement that the inside information in question is material.[77] Where information is clearly not generally available, materiality will be the sole

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Capital Market Equities Limited (1995) 7 NZCLC 260,718; *Regina v Rivkin* [2003] NSWSC 447; *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.

[71] 10.1 Material Information 10.1.1 Continuous Disclosure of Material Information: Without limiting any other Rule, every Issuer shall: (a) once it becomes aware of any Material Information concerning it, immediately release that Material Information to NZX, provided that this Rule shall not apply when:
(i) a reasonable person would not expect the information to be disclosed; and
(ii) the information is confidential and its confidentiality is maintained; and
(iii) one or more of the following applies:
(a) the release of information would be a breach of law; or
(b) the information concerns an incomplete proposal or
negotiation; or
(c) the information comprises matters of supposition or is
insufficiently definite to warrant disclosure; or
(d) the information is generated for the internal management
purposes of the Issuer; or
(e) the information is a trade secret.

[72] (2006) 9 NZCLC 264,179.

[73] *Auckland International Airport Ltd v Air New Zealand Ltd* (2006) 9 NZCLC 264,179 at paragraph 57 "It imports the standards of reason and sound judgement to the hypothetical person's expectation".

[74] *Auckland International Airport Ltd v Air New Zealand Ltd* (2006) 9 NZCLC 264,179 at paragraph 57.

[75] *Auckland International Airport Ltd v Air New Zealand Ltd* (2006) 9 NZCLC 264,179 at paragraph 56.

[76] Partridge, above n 57, at 312. As Roger Partridge points out: "If information is in fact price sensitive but would not be recognised as such by anyone who is not an expert, is that information not material information because a reasonable person would not regard it as price sensitive? If on the other hand "reasonable person" means a "reasonable expert" then the words add nothing and the test should simply have been stated as whether or not the information would have a material effect on the price of the securities if it were generally available".

[77] Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 39; Emerging Markets Committee of the International Organisation of Securities Commissions, *Insider Trading: How Jurisdictions Regulate It* (2003) at 2.

concept to sort illegal insider trading from legal trading.[78] Three main tests that can be identified are: the reasonable investor test, the probability/magnitude test, and the market impact test.[79]

a) The market impact test

The market impact test measures materiality by the information's impact on the share price.[80] This raises the question whether any impact however insignificant can qualify as material under the market impact test? If this proposition is accepted then virtually any factor influencing a person to buy or sell could qualify as "material" because almost all large trades will influence a share price slightly.[81] This does not sit well with the wording of the SMAA. The section reads "a reasonable person would expect, if it were generally available to the market, to have a *material* effect on the price of listed securities".[82] If the test for materiality was any change in price the word "material" in the above definition would be superfluous.[83] A minimum threshold must be found.

b) The reasonable investor test

This test measures materiality of information by the importance a reasonable investor would assign it.[84] The US *TSC*[85] materiality test states: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[86] Under the *TSC* test the information need not actually change the decision of the

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[78] Joan MacLeod Heminway has likened this requirement to the "Sorting Hat" at the Hogwarts School of Witchcraft and Wizardry: Joan MacLeod Heminway, 'Materiality guidance in the context of insider trading: a call for action' (Annual 2004) 52 *American University Law Review* 1131 at 1148.

[79] Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 39; Gordon Walker, Brent Fisse, and Ian Ramsay, (eds), *Securities regulation in Australia and New Zealand* (1998) at 606;

[80] Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 40.

[81] Bodie, Kane, and Marcus, above n 40, this phenomenon is called price impact.

[82] SMAA section 3(a) emphasis added.

[83] This is supported by comments of the International Organisation of Securities Commissions in its 2003 report: "In a case where the price of the security moves subsequent to a disclosure, the only issue to address may be whether the price movement was "substantial" enough to demonstrate the information's materiality." Emerging Markets Committee of the International Organisation of Securities Commissions, *Insider Trading: How Jurisdictions Regulate It* (2003) at 4.

[84] Walker, Fisse, and Ramsay, above n 79, at 606; Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 39.

[85] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132.

[86] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132.

shareholder when voting,[87] it is enough the information "assumed actual significance in the deliberations of the reasonable shareholder".[88]

It has been suggested this test is wider than the other materiality tests.[89] What becomes crucial is deciding what level of influence the information must have on the shareholder or investor. Voting and buying or selling shares are distinct actions and arguably imply different levels of materiality. Also the decision of whether to buy or sell could vary depending on the investor's style. In *Leadenhall*[90] a distinction was made between, short and medium term investors, and long term investors. This is because short and medium term investors would find it significant that a large portion of shares were coming out of escrow in the near future. They would be likely to wait until that had occurred to measure the effect on the share price. However for long term investors the evidence of materiality was more equivocal.[91] If this test is to be used the courts should make it explicit what the required effect on the investor is.

c) The probability/magnitude test

This test measures materiality by a balancing of the probability the event will occur with the magnitude of the event on the company if it does occur.[92] For example in *Texas Gulf Sulphur*[93] the test was laid out: "In each case, then, whether facts are material ... will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[94] This test is particularly useful for measuring soft, predictive information because it takes account of the uncertainty in the information (by looking at the probability something will eventuate), and the significance of the information by looking at its magnitude.

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[87] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132.
[88] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132. Further, "there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information".
[89] "Such an approach to defining materiality expands the possibilities that information may be classified as material." Emerging Markets Committee of the International Organisation of Securities Commissions, *Insider Trading: How Jurisdictions Regulate It* (2003) at 4.
[90] *Leadenhall Australia Ltd v Peptech Ltd* (1999) 33 ACSR 301.
[91] *Leadenhall Australia Ltd v Peptech Ltd* (1999) 33 ACSR 301.
[92] Walker, Fisse, and Ramsay, above n 79, at 606; Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 39; *Basic Inc v Levinson* (1988) 485 US 224.
[93] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[94] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968) at 849.

These tests have two features in common. They seek to evaluate the significance of the information and the reliability of the information.[95] These two features are relevant to an assessment of all types of information whether it is hard, soft, backward or forward looking. Its "significance" covers:

- Would it be enough to enter an investor's considerations when voting or deciding to buy or sell under the reasonable investor test?
- A minimum level of movement in the share price under the market impact test.
- The magnitude under the probability/magnitude test.

The "reliability" of information covers:

- Would a shareholder or investor act, or dismiss it as mere rumour, under the reasonable investor test?
- The "probability" side of the probability magnitude test.

When the different tests are simplified in this way it is much easier to see the importance of setting a threshold for both the reliability and significance of information to establish a clearer materiality test.

[95] Accounting standards also employ the concepts of reliability and relevance. Reliability under NZIRFS is defined as "information has the quality of reliability when it is free from material error and bias and can be depended on faithfully that which it either purports to represent or could reasonably be expected to represent." F.31 Accounting standards glossary. Relevance is defined as "information has the quality of relevance when it influences the economic decisions of users by helping them evaluate past, present, or future events or confirming, or correcting their past evaluations." F.26 Accounting Standards Glossary. This reinforces the idea that materiality tests seek to set a threshold for the reliability and significance (arguably very similar to relevance) of information.

CHAPTER TWO:
A COMPARISON OF MATERIALITY UNDER THE MARKET FAIRNESS AND FIDUCIARY REGIMES.

For the following analysis "insider" refers to a traditional insider, someone with a connection to the company whose shares are traded such as a director, officer, and employee. "Outsider" will be the opposite, someone with no connection to the company. This will facilitate the comparison of law that restricts only insiders from insider trading with law that restricts both insiders and outsiders from insider trading.

A. THE FIDUCAIRY REGIMES

1. *Materiality prior to the Securities Markets Act 1988*

Before the enactment of the SMA, New Zealand had no formal prohibition on insider trading.[96] Instead, the courts relied on general fiduciary duties owed by an insider.[97] Fiduciary duties in the context of company directors consist of two overarching duties: the duty not to profit from a position of trust[98], and the duty of loyalty. In *NZ Netherland Society v Kuys*[99] the Privy Council held that the obligation not to profit from a position of trust or not to allow a conflict to arise between duty and interest is one of strictness.[100] Related to the duty not to profit, is the duty not to take advantage of information acquired in a fiduciary capacity; the duty of confidence. *S.S.C. & B: Lintas New Zealand Ltd. V. Murphy & Anor*[101] summarises that "it is not so much a matter that the information itself is confidential but that the information is was acquired in circumstances whereby the recipient of the information is expected to keep it confidential and

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[96] Peter Ratner and Cathy Quinn, *Insider Trading,* New Zealand Law Society Seminar (1990) at paragraph 1.1.
[97] Phillip Anisman, *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives* An Issues Paper prepared for the Working Party on Insider Trading of the National Companies and Securities Commission (1986) at 1.
[98] *Pacifica Shipping Co. Ltd v Andersen & Ors.* (1985) 2 NZCLC 99,178 (HC); *New Zealand Netherlands Society "Oranje" Inc. v. Kuys and the Windmill Post Ltd.* [1973] 2 NZLR 163 (PC); "fiduciary theory holds that a person in a position of trust cannot have a personal profit from his position without the informed consent of his beneficiaries. Some regard this as a moral axiom. We do not disagree with them." Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at paragraph 4.5.1.
[99] *New Zealand Netherlands Society "Oranje" Inc. v. Kuys and the Windmill Post Ltd.* [1973] 2 NZLR 163 (PC).
[100] *New Zealand Netherlands Society "Oranje" Inc. v. Kuys and the Windmill Post Ltd.* [1973] 2 NZLR 163 (PC) at 166. The Court agreed with the appellant's contention that "he had acquired ownership of the newspaper while he held this (fiduciary) position and by virtue of it. Admittedly it would be possible for the society to release him from accountability...but this could only be done by an arrangement freely arrived at after full disclosure of all relevant matters. "at 166; however the Court found Kuys' potential fiduciary duty to hold the new newspaper in a fiduciary capacity had been displaced.
[101] *S.S.C & B Lintas New Zealand Limited v Murphy & Truman* (1982) 1 NZCLC 95,044.

not to use the information to the detriment of the person or persons conveying the information to him."[102] This was confirmed in *Pacifica Shipping Co Ltd v Anderson & Ors.*[103]

Early cases involved a direct transaction between a director or officer and a shareholder.[104] *Percival v Wright*[105] established that an officer of a corporation did not automatically owe a fiduciary duty to the shareholder to avoid misusing corporate information for his or her own benefit in such a transaction.[106] *Percival* held that to impose such a duty would impose too heavy a burden on directors, and might encourage directors to disclose confidential information in circumstances that would be detrimental to the company.[107]

The first case to deal with this in New Zealand was *Coleman v Myers.*[108] The Court of Appeal (CA) extended the reach of the directors' fiduciary duties in New Zealand, to the shareholders of the company in some circumstances.[109] In *Coleman* a father son duo convinced members of the family who were also shareholders to sell their shares to the son. A duty arose from the family character of the company, the position of the father and son as directors of the company, the father and son's high degree of inside knowledge, and the way they went about the takeover and persuasion of the shareholders.[110] The plan to finance a 100 percent takeover of the company entirely by resort to its own assets without having to contribute any assets allowed the son

[102] *S.S.C & B Lintas New Zealand Limited v Murphy & Truman* (1982) 1 NZCLC 95,044, at 393. In *Lintas* an interlocutory injunction was issued preventing the ex director and employees of an advertising agency performing services for the former clients of the ad agency for three months. The Court found it was arguable the defendants were using confidential information obtained while being employed by the ad agency. In such circumstances the information was confidential and the defendant's use of it was a breach of confidence

[103] (1985) 2 NZCLC. Pacifica operated a costal shipping service, and decided to acquire another vessel. A technical consultant, a director of Pacifica, and the owner of the vessel to be acquired, breached duties by incorporating another company for the purpose of taking up the opportunity to the disadvantage of Pacifica. Specifically, the case against the director was one of breach of fiduciary duty, and application of company property for his own benefit. The director had applied company property (information available to Pacifica) for his own purposes. Therefore the essential requirements for breach of confidence are: the information must be of a confidential nature, and the information must have been communicated in circumstances giving rise to an obligation of confidence.

[104] *Coleman v Myers* [1977] 2 N.Z.L.R 225.

[105] (1902) 2 Ch 421.

[106] *Percival v Wright* [1902] 2 Ch 421; Anisman, above n 97, at 1.

[107] *Percival v Wright* [1902] 2 Ch 421. However, *Allen v Hyatt* (1914) 30 TLR 444 reached the opposite conclusion to *Percival* holding that the directors could, in some circumstances, owe a duty to shareholders of the company. In *Allen* the directors had induced shareholders to give them the option to purchase their shares. They did so by representing that this was the necessary to effect an amalgamation. The Court found the crucial difference from *Percival* was that the directors had held themselves out to the individual shareholders as acting for them on the same footing as they were acting for the company "they had undertaken to sell shares of the shareholders in an agency capacity".

[108] *Coleman v Myers* [1977] 2 N.Z.L.R 225.

[109] *Coleman v Myers* [1977] 2 N.Z.L.R 225. This was despite the authority to the contrary from the UK in *Percival v Wright* [1902] 2 Ch 421. Cooke J argued *Percival* carried little weight in New Zealand for a general proposition that no fiduciary duty is owed by a director dealing with individual shareholders to disclose information. Additionally *Percival* only stood for the proposition that such a fiduciary duty did not automatically arise, leaving room for the imposition of one in special circumstances. *Coleman v Myers* [1977] 2 N.Z.L.R 225 at 330.

[110] *Coleman v Myers* [1977] 2 N.Z.L.R 225.

"prospects of brilliant gain". The father and son held themselves out as people in whom confidence should be held because of their inside knowledge; in doing so they convinced the shareholders to sell to the son at $4.80. Because this was done without informing the shareholders of the profitability of the regime for the son, it was a breach of the fiduciary duty.

The duty in *Coleman* belonged to the class of duty imposed based on the particular circumstances; it was a "fiduciary arising out of special facts".[111] The CA was clearly influenced by both the decision in *Allen*[112] and the "special facts doctrine" that had developed in *Strong v Repide*[113] in the US.[114] This doctrine held that fiduciary obligation of disclosure came into existence only where "special facts" exist affecting the value of the shares.[115]

Therefore, prior to the SMA, fiduciary duties owed by directors prevented them from withholding significant information to the people they were dealing with. Trading while in possession of significant information was a breach of an insider's duties. It will usually be in the interests of shareholders to know all material information without delay.[116] The insider who trades on inside information withholds information long enough to complete the trade.[117] This is in conflict with the shareholders' interests. Additionally most insiders use their position of trust to make a profit. This is a misuse of their special position and access to information and can be seen as a breach of the overarching duty of loyalty.

Coleman was the first case to expressly adopt a test for materiality in New Zealand. Throughout the decision it is clear that the nature of the underlying fiduciary duty discussed above underpins

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[111] *Coleman v Myers* [1977] 2 N.Z.L.R 225 at 331;*Tate v Williamson* (1866) LR 2 Ch App 55; *Tufton v Sperni* [1952] 2 TLR 516 approved in *New Zealand Netherlands Society "Oranje" Inc v Kuys* [1973] 2 NZLR 163 and *Lloyds Bank v Bundy* [1975] QB 326. Often such cases argued to be undue influence: however not correct to say so as the vendor's mind has not been dominated.
[112] *Coleman v Myers* [1977] 2 N.Z.L.R 225 at 329.
[113] *Strong v Repide* 213 U.S. 419 (1909). In *Strong* a former shareholder of a company had been induced to sell her shares to the general manager of the company. The general manager knew the company was about to enter an extremely profitable contract with the Philippines government. The special facts, (the defendant's insider position and the significance of the information) compelled disclosure.
[114] *Coleman v Myers* [1977] 2 N.Z.L.R 225; In the US two methods of extending the duty were used. The first was to declare that directors owed a fiduciary duty in circumstances where they were dealing directly with shareholders, the second was to use the "special facts doctrine", Anisman, above n 106, at 3;
[115] Anisman, above n 97, at 3; *Strong v Repide* (1909) 213 U.S. 419 at 431,"By reason of such ownership and agency, and his participation as such owner and agent in the negotiations then going on, no one knew as well as he the exact condition of such negotiations. No one knew as well as he the probability of the sale of the lands to the government. No one knew as well as he the probable price that might be obtained on such sale."; *Coleman v Myers* [1977] 2 N.Z.L.R 225.
[116] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) paragraph 4.5.3.
[117] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) paragraph 4.5.3

the definition of materiality. The test is taken directly from the US approach in *TSC* [118] and is a true "reasonable investor test".

Cooke J stated the test in the following way: material facts are "those considerations which can reasonably be said, in a particular case, to be likely materially to affect the mind of a vendor or purchaser".[119] The *TSC* test[120] was expressly adopted in support. From the surrounding discussion about the content of the duty, it is clear a high level of disclosure was required. Cooke J rejected that the mind of the purchaser had to be dominated by the vendor (the directors).[121] The inherent nature of the fiduciary duty required the utmost candour.[122] For example Cooke J cited *Tufton v Sperni*[123] saying, "blind and unquestioning trust is not required... he owed him a duty of care and candour, and was bound to make to him full disclosure of all material facts."

On the topic of what information was material, Cooke J continued "In his judgement Mahon J uses sometimes the expression might influence the shareholder, sometimes would. ... I think it is often easier to assess whether a statement or omission is in the circumstances truly significant that propound a watertight test. If forced to a formula I would select one somewhere between the alternatives just mentioned."[124] Cooke J also relied on *Hatrick v Commissioner of Inland Revenue*.[125] In *Hatrick* shares had to be valued for the purpose of stamp and estate duties. The CA held:

> the commissioner is bound to take into account all those matters which would, in fact, influence a potential purchaser. This does not mean that he must make allowances for mere possibilities....he is obliged to give attention only to those considerations which can reasonably be said... to be likely materially to affect the mind of a vendor or purchaser.[126]

Coleman expresses the reasonable investor test slightly differently to *TSC*. Things that would affect the reasonable shareholder when deciding to vote (the *TSC* test) are not necessarily the same as those things that will materially affect a vendor or purchaser; however it is assumed the

[118] *TSC Industries v Northway Inc* (1976) 426 US 438,449.
[119] *Coleman v Myers* [1977] 2 NZLR 225 at 334; see *Hatrick v Commissioner of Inland Revenue* [1963] NZLR 641.
[120] "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." *TSC Industries Inc v Northway Inc* 426 US 438 (1976) at 2132.
[121] *Coleman v Myers* [1977] 2 NZLR 225 at 332.
[122] *Tufton v Sperni* [1952] 2 TLR 516 at 520.
[123] *Tufton v Sperni* [1952] 2 TLR 516.
[124] *Coleman v Myers* [1977] 2 NZLR 225 at 333.
[125] *Hatrick v Commissioner of Inland Revenue* [1963] NZLR 641.
[126] *Hatrick v Commissioner of Inland Revenue* [1963] NZLR 641 at 661.

intent was to produce the same result.[127] Because *Coleman* did not involve transactions on an anonymous exchange evidence of a share price movement was irrelevant. The focus was on the deliberative process of the reasonable shareholder. It seems the CA accepted, in accordance with *TSC* that to be material, the information need not actually changes the mind of the shareholder, vendor or purchaser.

[127] The test is "applicable here in its entirety" *Coleman v Myers* [1977] 2 N.Z.L.R 225 at 334.

2. *"Materiality" in the US under a fiduciary regime*

In the US, the insider trading regime, and the *TSC* test, was crafted out of one all encompassing anti-fraud provision, section 10b-5 of the Securities Exchange Act 1934.[128] This test prohibits the use of a securities exchange to "employ any scheme device or artifice to defraud"[129] or to "make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading."[130] Section 10b-5 was not designed with insider trading in mind,[131] but because the Securities Exchange Commission (SEC) could have an active role in enforcing 10b-5 it became the primary way of preventing insider trading. Fiduciary obligations are not mentioned in the Securities Exchange Act 1934 but the courts have interpreted the legislation as qualified by the need to show a breach of fiduciary duty.[132]

The first case to interpret rule 10b-5 was *Cady Roberts & Co* in 1961.[133] This case established the "disclose or abstain" rule that requires people with material non-public information to either disclose it or abstain from trading. This US approach is grounded in fiduciary obligations.[134] Langevoort explains the basis for requiring "disclosure" in the US stating:

> Requiring public disclosure by the insider in the open-market situation furthers a significant objective underlying the fiduciary disclosure rule-that of preventing unjust enrichment. The disclosure requirement is the federal analogue to the agency principle that personal profits made from the agent's use of confidential information are held in trust for the benefit of the principal, even where the agent's conduct results in no harm to the principal.[135]

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[128] Securities Exchange Act 1934 section 10b-5 states: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
(1) to employ any device, scheme, or artifice to defraud,
(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.
[129] Securities Exchange Act 1934 section 10b-5.
[130] Securities Exchange Act 1934 section 10b-5.
[131] An earlier attempt at directly regulating insider trading had proved unsuccessful. Section 16 of the Securities Exchange Act 1934 contained a number of controls on director's ownership of shares. However it contained loopholes that weakened its effectiveness and was limited in scope. Nasser Arshadi and Thomas H Eyssell, *The Law and Finance of Corporate Insider Trading: Theory and Evidence* (1993) at 44.
[132] *Chiarella v. United States* (1980) 445 U.S. 222.
[133] *Cady Roberts & Co* (1961) 40 S.E.C. 907.
[134] "When an insider buys immediately before the announcement of good news or sells just before bad, his profit arises by virtue of his fiduciary status and the resulting access to the non public information that created the opportunity for low-risk wealth", Donald C Langevoort, 'Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement' (1982) 70 *California Law Review* 1 at 19.
[135] Langevoort, above n 134, at 19.

This was endorsed in *SEC v Texas Gulf Sulphur Co* in 1968[136] where it was held that an insider's duty to disclose or abstain arose in "situations which are essentially extraordinary in nature and which are reasonably certain to have a substantial effect on the market price of the security if disclosed."[137] Although this test was overruled by *TSC*, two features of *Texas* survived. Firstly *Texas* introduced the idea that the fact of trading can be used to establish the materiality of the information.[138] And secondly *Texas* introduced the "probability magnitude" test that was later reasserted in *Basic.*[139]

a) The TSC test

The test in TSC has been the "single, judicially created and construed, legal standard applicable to materiality determinations under rule 10b-5" for over fourteen years.[140] Because of the broad application of rule 10b-5 the *TSC* test developed in the context of analysing whether a proxy statement was materially misleading.

TSC was an action brought by a shareholder (Northway) claiming that TSC's proxy statement was materially misleading in violation of the Securities Exchange Act section 14(a).[141] Northway argued that the statement was incomplete, therefore misleading because it failed to state that this prior transfer of interests in TSC had resulted in a change of control.

On materiality the Court stated that it is "universally agreed"[142] the question is one involving the significance of an omitted or misrepresented fact to a reasonable investor. The Court also recognised that "variations in the formulation of a general test....occur in the articulation of just

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[136] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[137] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[138] "nevertheless, the timing by those who knew of it of their stock purchases and their purchases of short-term calls- purchases in some cases by individuals who had never before purchased calls or even TGS stock- virtually compels the inference that the insiders were influenced by the drilling results. This insider trading activity, which surely constitutes highly pertinent evidence and the only truly objective evidence of the materiality of the K-55-1 discovery."*SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[139] *Basic Inc v Levinson* (1988) 485 US 224.
[140] Heminway, above n 78, at 1150; The SEC has recently expressly reaffirmed the TSC standard for determinations of materiality in Release No. 34-43154, 65 Fed. Reg. 51,716 (Aug 24, 2000).
[141] The proxy statement was issued to TSC shareholders approving the proposed acquisition by National. The acquisition was successful and TSC was liquidated. Earlier that year the TSC founder had sold his 34% shareholding to National. After the sale the founder resigned from the board and 5 National nominees were placed on the board. This sale earlier in the year had effectively given National control of TSC. *TSC Industries v Northway Inc* (1976) 426 US 438,449 at page 2128.
[142] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2130.

how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment."[143]

The Court settled on the following test: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[144] The proxy statement contained some information about the control of TSC, for example it was "prominently displayed" that National owned 34% of the shares and that 5 out of 10 TSC directors were National nominees. In these circumstances it could not be said that the omission of a statement expressly identifying the chairman of the board, or the omission of a statement explaining that National "may be deemed a parent of TSC" was a material omission as a matter of law.[145]

Despite being predominantly a "reasonable investor" test, the *TSC* judgment combines elements the market impact test. The Court stated further that a fact would be material if it altered the total mix:

> Under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information.[146]

To determine whether the total mix has been significantly altered, courts have frequently resorted to evidence of price movements to ascertain the significance of the information.[147] Therefore the *TSC* materiality test is predominantly "reasonable investor" however leaves room for the application of market impact factors to supplement an argument that the information was material.

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[143] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2130, the Court rejected the threshold "all facts a reasonable shareholder might consider important" as too low; *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132, the Court also recognised at the other end of the scale "Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good. ...if the standard of materiality is unnecessarily low....liability may cause it simply to bury the shareholders in an avalanche of trivial information, a result that is hardly conducive to informed decision making."

[144] *TSC Industries v Northway Inc* (1976) 426 US 438,449 2132.

[145] The securities offered to TSC shareholders comprised a package of National preferred stock and warrants. A second issue was whether the proxy statement's reference to the offer being a "substantial premium" over the market price for the securities was misleading. The Court rejected that as a matter of law this was incorrect. *TSC Industries v Northway Inc* (1976) 426 US 438,449 2138.

[146] *TSC Industries v Northway Inc* (1976) 426 US 438,449 2132.

[147] Lee, above n 2, at 655.

b) The development of a "qualitative standard" in disclosure requirements

The omission of a material fact in disclosure requirements under the Securities Exchange Act 1934 has been equated to the possession of material information for the purposes of insider trading.[148] There are two "strains" of materiality in the disclosure context, quantitative and qualitative.[149] Prior to *TSC* in 1976, there was no single standard for materiality in the US. Instead the SEC required disclosure of specific items of information. From 1933 to the 1970's decisions about materiality were almost always based on quantitative facts.[150] For example the SEC created guidelines on (mostly quantitative) information that must be disclosed.[151] The SEC guidelines sometimes included "qualitative-like"[152] information. For example, the SEC requires reporting of self-dealing transactions and conflicts of interest with employers.[153] The SEC also requires the reporting of criminal charges and convictions and any civil judgements involving violations of the securities laws.[154] These items are qualitative because, in contrast to the quantitative reporting of cash flows, profits, liabilities, the effect on the company's financial performance (and consequently the share price) is less clear.[155] It should be noted at this early stage, forward looking "predictive information" was prohibited from disclosure regardless of its quantitative or qualitative materiality due to the perceived danger of misleading investors.[156]

The SEC began to grapple with the problem of information that seemed relevant to shareholders but did not have an obvious effect on the financial situation of the company. In the 1970's the

148 "We now expressly adopt the TSC Industries standard of materiality [in the] Rule 10b-5 context."*Basic Inc v Levinson* (1988) 485 US 224 at 983.

149 "There are essentially two strains of materiality, qualitative and quantitative materiality relies exclusively on numerical benchmarks to determine the materiality of misstatement or omission, while qualitative materiality considers the noteworthiness of a misstatement or omission independent on its impact on the company's raw financial figures", Miller, above n 1, at 363.

150 Fedders, above n 42, at 46.

151 Regulation S-B, 17 C.F.R. pt 228 (1998); Regulation S-K, 17 C.F.R. pt. 229; Regulation S-X, 17 C.F.R pt. 210; Fedders, above n 42, at 45.

152 Fedders, above n 42, at 45.

153 Item 404 of SEC Regulation S-K, 17 C.F.R 229.404.

154 Fedders, above n 42, at 45; Item 401(f) of SEC Regulation S-K, 17 C.F.R. 229.401.

155 Fedders, above n 42, at 46; Fedders, a critic of the qualitative standard, aptly describes the problem of determining information's materiality: "Economic or quantitative materiality is characterised by facts that significantly affect a company's financial performance, and consequently, its stock price. The disclosure determinations are made by measuring the amount, number, or percentage of assets, earnings or liabilities. While judgements of quantitative materiality may be reached objectively without surmise, the means to reach qualitative determinations of materiality encompass subjective components and judgements and have almost no relationship to the financial condition of a company. Determinations as to whether management conduct is qualitatively material are measured by quality, kind, and essential character or conduct. Those decisions cannot be made by simply employing arithmetic. Reasonable people will differ in their views as to whether qualitative information is material."

156 Sullivan, above n 35, at 209, to begin with the SEC prohibited the disclosure of predictive information due to its unreliability. However the SEC re-evaluated this position in the 1970's.

SEC attempted to introduce a general qualitative standard of materiality.[157] The rationale for this was based on the idea that qualitative facts can reveal information about the integrity of the management. It was justified on the basis such facts would be influential in the voting decisions of investors.

The development of this qualitative materiality clearly indicates the potentially wide reach of the *TSC* test. The type of information that might affect a voter's decision is extended to non-economically significant information if a qualitative standard is accepted. Perhaps it is due to this background development of qualitative materiality that the *TSC* test is stated in terms that do not require an economic impact on the company or share price.[158]

In 1999 the SEC released the Staff Accounting Bulletin 99 (SAB 99) that expressly recognised that the TSC reference to the "total mix" contains both quantitative and qualitative factors.[159] SAB 99 reasserts a qualitative standard for materiality[160] because it strongly rejects reliance on numerical thresholds to establish materiality.[161] SAB 99 has been criticised as importing a dysfunctional and undesirable materiality standard.[162] It highlights how the materiality threshold has been significantly lowered in the US. It is a clear point of difference to the New Zealand sections of the SMAA that mandate a likely effect on the price of shares; before qualitative information could be material in the insider trading context in New Zealand it would need to reach the point of potentially impacting on the price of the shares.

c) The distinction between merger negotiations and other soft, forward looking information

Unlike New Zealand or Australia, US courts and commentators treat information about mergers differently to other types of predictive information and therefore use a different materiality test for this type of information. Commentators have distinguished this type of information from other types of soft information on the basis that the existence of the possibility of a takeover or

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157 For instance information about a conviction for an illegal campaign contribution should be disclosed because it speaks to the integrity of management and the functioning of the corporation. Miller, above n 1, at 368.

158 Following *TSC*, in 1980 the Financial Accounting Standards Board (FASB) further endorsed a qualitative standard for materiality, identifying the key elements as reliability (that requires representational faithfulness, verifiability, and neutrality,) and relevance (timeliness and predictive value). Statement of Financial Accounting Concepts no 2 Qualitative Characteristics of Accounting Information in II FASB Original Pronouncements (1980).

159 Securities and Exchange Commission, "SEC Staff Accounting Bulletin 99", August 12 1999, 17 CFR Part 211; Kenneth C Fang and Brad Jacobs, 'Clarifying and Protecting Materiality Standards in Financial Statements: A Review of SEC Staff Accounting Bulletin 99' (1999-2000) 55 *Business Lawyer* 1039 at 1039.

160 Miller, above n 1, at 379.

161 Miller, above n 1, at 363; The Courts and the SEC have refused to adopt any "bright line" guidelines for instance to identify a material overstatement in the financial report of a company. Although 5% had been adopted as a "rule of thumb".

162 Miller, above n 1, at 387.

merger can be so significant that regardless of its probability it is a hard fact representing a present state of affairs.[163] Victor Brudney distinguishes information about possible mergers and takeovers from the previous information due to the fact the information does not itself contain any especially knowledgeable estimates of the likelihood that the contingent events will occur.[164] Brudney suggests this information is analytically like many other forms of information, for example statement of expenditures made on research and development. This information expresses corporate estimates of contingent events but does not embody "express inferences about intermediate components of, or ultimate effect on, price."[165] Rather the information simply "informs about the possibility that is likely to be of importance to an investor".[166]

Basic Inc v Levinson[167] adopted the *TSC* test in a case of insider trading leading up to a merger. Sellers of stock during the period prior to the formal announcement of a merger alleged that material misrepresentations had been made because Basic had denied the existence of merger negotiations[168] prior to this official announcement.[169] Following this it was revealed that the company had been approached and the following day the board endorsed Combustion's offer of $46 per share.

The Court rejected that information about mergers should not have to be disclosed until an agreement as to price and structure had been made,[170]stating that although a bright line rule may be more convenient for managers ease of application alone is not an excuse for ignoring the purpose of the Act.[171] The Court expressly adopted the *TSC* test and held it was applicable to the merger context.[172] The Court also cites the probability/magnitude test set out in *Texas*. When analysing this it seems the Court emphasised the fact that the existence of merger negotiations

[163] Sullivan, above n 35, at 221, the existence of merger negotiations is a present fact therefore differs from truly predictive information.
[164] "The reasons for distinguishing between information about merger negotiations and these other kinds of information derive largely from considerations of degree with respect to the unusual and discrete character of the event, it's likely substantial impact of the price of the securities, and its wholly contingent character", Brudney, above n 35, at 723.
[165] Brudney, above n 35, at 723.
[166] Brudney, above n 35, at 723.
[167] *Basic Inc v Levinson* (1988) 485 US 224.
[168] As early as 1965-66 Combustion Engineering Inc expressed interest in acquiring Basic. At this stage they were deterred because of competition laws. In 1976 a changed regulatory environment renewed Combustion's interest in Basic. In October 1976 a "strategic plan" was created including the objective of acquiring Basic. In September 1976 Combustion representatives met with Basic officers and directors.
[169] Throughout 1977 and 1978 were three public statements issued by Basic that formed the basis of the allegations. On September 25 1978, in response to NYSE enquiry Basic released statement, "management is unaware of any present or pending company development that would result in the abnormally heavy trading activity and price fluctuation in company shares that have been experienced in the past few days"
[170] *Basic Inc v Levinson* (1988) 485 US 224 at 984.
[171] *Basic Inc v Levinson* (1988) 485 US 224 at 986.
[172] The Court however declined to assert it as applicable to all types of speculative information.

could be so important in a small corporation the fact becomes material at an earlier stage than when the transaction is less important. To determine the probability element, the Court suggested the following will be relevant: Indicia of interest in the transaction in the highest corporate levels[173] such as board resolutions, instructions to investment bankers, actual negotiations between principals. To determine the magnitude of the transaction factors such as the size of the two corporate entities, and the potential premiums over market value will be relevant.[174] However no particular event or factor is necessary by itself to render information material.[175] In conclusion the Court stated "as we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information."[176] enforcing that the "reasonable investor" standard is still the dominant test.

The misappropriation theory was developed *O'Hagan*[177] to get around cases where it seemed the insider trading was inappropriate but no obvious fiduciary connection could be found. O'Hagan was a lawyer for Dorsey & Whitney, a law firm advising Grand Metropolitan in relation to its tender offer for Pillsbury Company. O'Hagan purchased Pillsbury call options. Because he owed no duty to Pillsbury the Court accepted that a "misappropriation" of his client's information (Grand Met) constituted a deception "in connection with a securities transaction" and therefore breached rule 10b-5.[178] Therefore the Court craftily extended the reach of the fiduciary approach to catch outsiders where necessary.

d) Conclusion

A full analysis of US insider trading law is outside the scope of this research. However from analysis of the leading cases it is evident that the approach to materiality is broad. Under the US materiality standard there is no requirement the information would actually make the insider trade and information that can be material includes qualitative information that would not necessarily affect the company's share price. This has been criticised as without evidence of trading, there are no obvious measures of the information's significance.[179] Also the US courts seem to distinguish merger information from other types. It seems in the context of mergers the

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[173] *Basic Inc v Levinson* (1988) 485 US 224 at 987
[174] *Basic Inc v Levinson* (1988) 485 US 224 at 987
[175] *Basic Inc v Levinson* (1988) 485 US 224 at 987.
[176] *Basic Inc v Levinson* (1988) 485 US 224 at 988
[177] *United States v O'Hagan* 521 U.S. 642 (1997)
[178] *United States v O'Hagan* 521 U.S. 642 (1997)
[179] Richard C Sauer, 'The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws' (2007) 62(2) *Business Lawyer* 317(41) at 323.

high significance of the existence of negotiations overrides the reliability element. The *TSC* test is still accepted as the relevant legal standard to judge materiality.[180]

3. *How was the fiduciary rationale expressed in the SMA?*

The duties in *Coleman* do not easily apply to situations other than the classic director/shareholder dealing.[181] Transactions on a stock exchange can be made with any potential investor, not just current shareholders.[182] In this situation it is difficult to extend the fiduciary duty as there is no pre-existing relationship of confidence or trust.

Therefore, a fiduciary basis struggles in some ways to provide an adequate framework for regulating all cases of insider trading.[183] A combination of the fiduciary principle with other theories must be used. In the US, reliance is placed on the Efficient Markets Hypothesis to fill the gaps in the fiduciary theory.[184] In the absence of a positive representation, for example silence on a material matter while trading, it is hard to identify how the anonymous exchange trader is harmed as he or she would have traded anyway. The US uses market efficiency arguments to say that investors rely on the efficiency of the market price of the security.

But the fiduciary rationale does not catch all potential inside traders, for example people who have no connection to the company or its insiders whatsoever. One example is an "offeror or a person about to enter a contract with a company which is likely to enhance the other company's profitability".[185] In concrete terms for example, if a director of Air New Zealand knew it would be launching a takeover bid for Origin Pacific, the knowledge held by the director, that Origin Pacific shares would probably increase in value as a result of Air New Zealand's bid, would be held independently of any duty to Origin Pacific's shareholders. This limitation of the fiduciary

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[180] This is clear from the SEC's approval of it in Securities and Exchange Commission, "SEC Staff Accounting Bulletin 99", August 12 1999, 17 CFR Part 211.

[181] Anisman, above n 97, at 10 "Because they derive information from a position of trust which gives them an advantage over their ultimate beneficiaries, directors and officers are easily treated as owing fiduciary obligations to existing shareholders".

[182] For example where a director sells his or her shares to a new investor.

[183] Anisman, above n 97 at 10 "While the fiduciary concept provides a useful starting point, it requires supplementation to complete even the definitional task."

[184]The approach taken by the US fraud on the market theory: "A derivative of the efficient market hypothesis the fraud on the market theory assumes that investors rely on the market price of a security as a reflection of its value. Thus a misleading statement that distorts securities prices is fraudulent even if the average security holder has no knowledge of the statement" Mitchell, Mark L and Netter, Jeffry M "The Role of Financial Economics in Securities Fraud Cases: Applications at the Securities and Exchange Commission" (1993) 49 *Business Lawyer* 545 at 547.

[185] Anisman, above n 97, at 11.

approach is illustrated in the Commission's Fletcher Challenge Report.[186] The information, that the "company is considering a major restructuring of one of its divisions",[187] was posted on a company notice board. It was faxed from AB to CD. It was later taken by EF from CD's desk.[188] Neither EF nor CD could be insiders because under section 3(1)(e) of the SMA a person must have "received inside information in confidence from a person who received inside information in confidence from a primary issuer."[189]

Under the SMA there was no express requirement for a fiduciary relationship to be established between the insider and the person with whom he or she trades.[190] However, the influence of the fiduciary theory is clear from the requirement the offender must be an "insider"[191] and receive the information by reason of his or her position as an insider.[192] By requiring the person is a true "insider" of the company, and has the information by reason of his or her position, the Act deems a fiduciary-like relationship to exist between the insiders and the person with whom they trade.[193]

Despite the lack of an express requirement of a fiduciary relationship, the US fiduciary approach had a strong influence on the SMA. The influence of the on the US approach is evident in the Commission's Report to the Minister of Justice. The Commission claims "the basis of the principles is adopted from the concept known as "disclose or abstain".[194] On the face of it the commission have adopted the term from the United States case law, citing *Texas*[195] for the basis of this principle.

Because of the strong influence of the fiduciary theory on the SMA and the fact the US materiality test had been adopted in *Coleman*, it was predicted at the outset the court's approach

[186] Securities Commission, *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999,* Insider Trading Law and Practice (20 November 2000).
[187] Securities Commission, *Fletcher Challenge Report,* at paragraph 102.
[188] Ibid, at paragraph 104.
[189] Ibid, at paragraph 124.
[190] Commentators on the Securities Amendment Act 1988, the subject of the commission's report, have stated "the Securities Amendment Act 1988...introduced for the first time in New Zealand an express prohibition against insider trading without resort to the need to establish the existence of fiduciary or other duties." Ratner and Quinn, above 96, at 1.
[191] SMA section 3.
[192] SMA sections 3(b), (d) and (f).
[193] "The second approach followed in the cases and works of scholarship is a development of personal obligations. This obtains its most general expression in the action for breach of confidence, carrying remedies of compensatory damages, forfeiture of profits and personal injunctions. Our proposals are derived from this line of approach." Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at paragraph 1.4.
[194] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at paragraph 3.1.
[195] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).

to materiality under the SMA would be closely aligned to the US test. Peter Ratner and Cathy Quinn commented on the application of US materiality standard to New Zealand law "while it is true that the words of the statutes are significantly different we believe the issue is the same and New Zealand Courts will look to the extensive law in the United States for guidance."[196] This further supports the statement of *Coleman* that the US test for materiality stated in *TSC* is "applicable here in its entirety".[197]

4. *Materiality under the Securities Markets Act 1988*

The Commission's Report to the Minister of Justice did not recommend the use of the word "material" to define inside information.[198] The Report described the approach to inside information in the following way:

> It is a difficult question to decide whether any particular item of information has affected prices or is likely to affect them. Those are matters of opinion. They are, we think, proper questions for resolution on the evidence of experts familiar with the market. If the evidence becomes disclosed to the market, evidence of a market reaction should be admissible and would, we believe, have a strong effect upon the result of a disputed case. If the information does not become disclosed to the market, the likelihood of a price reaction if the market had known is debatable. That likelihood should be assessed by applying robust common sense aided by expert evidence. Powerful considerations would be the nature of the information, the lapse of time, and intermediate announcements and price movements.[199]

However, subsequently the word "material" was included in the SMA in the definition of "inside information".[200] Although little trace of the underlying fiduciary basis can be found in the Commission's suggestions above, it must be remembered this proposed test, (an analysis of the nature time and intermediate and subsequent price movements) is to apply where a link to the company has been established. Therefore the fiduciary theory has already done work by ensuring the person is an insider, and that they received the information by virtue of that position.

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[196] Ratner and Quinn, above n 96, at paragraph 2.9.
[197] *Coleman v Myers* [1977] 2 N.Z.L.R 225 at 334.
[198] "As to "material", we think that, in this context, this is a potentially confusing term which adds nothing by way of elucidation of the subject matter. If the information in question "would be likely to affect the price of the security if it was published" (the phrase we use in para 2.2), then that information may fairly be taken to be "material"" Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at 38.
[199] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at 8.
[200] SMA section 2: "Inside information...means information which is not publicly available; and would or would be likely to, affect materially the price of securities of the public issuer if it was publicly available."

a) The case law in New Zealand

From analysing the cases it is clear the courts did not expressly resort to the reasonable investor test. The courts used elements of the various tests in combination with one another at times, and did not expressly state which test was being applied.

It was clear that under the SMA there was no requirement for a prosecutor to "establish affirmatively" any state of mind on the part of an insider.[201] Therefore in *Wilson Neill* the fact that the company directors had not analysed the material containing the inside information was irrelevant to liability.

The courts have been willing to look at the potential for price movement or actual subsequent price movements, utilising the market impact test. For example in *Kincaid*[202] Henry J focussed on the likelihood the information would impact the share price, rather than the influence on the reasonable investor.[203] The level of impact on the share price necessary to meet the material threshold is not clear from this judgment. However the Commission's report into the dealing said "on any measure a 55 million net influence is material."[204] Henry J reached the conclusion that the information was probably material despite a number of experts giving evidence that the information was not material. The experts argued that since the users of the accounts would be able to see the general trend in the company's performance (that the company had recovered slightly from 1989 position) the fact this recovery was overstated would not be significant. This approach stressed the effect on the users of the accounts, stating that they would not be misled.[205] The approach was akin to the "reasonable investor" test however Henry J clearly favoured the market impact approach.

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[201] This was recommended in Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at page 37, 4.9.5(b), and was confirmed in *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152.

[202] *Re Bank of New Zealand: Kincaid v Capital Market Equities Limited* (1995) 7 NZCLC 260,718.

[203] "Looked at overall I am not satisfied that it is not arguable that this information would be likely to materially affect the share price" *Re Bank of New Zealand: Kincaid v Capital Market Equities Limited* (1995) 7 NZCLC 260,718 at 23.

[204] Securities Commission, *Report of an Enquiry into Arrangements Entered Into By Bank of New Zealand in March 1988* (May 1993) paragraph 23.40(c); *Re Bank of New Zealand: Kincaid v Capital Market Equities Limited* (1995) 7 NZCLC 260,718 at 23.

[205] "He gave the opinion that users of the 1990 accounts would not be misled because they would see the results were still a long way less than the profits of 1987 and 1988, but with a recovery from the 1989 position." *Re Bank of New Zealand: Kincaid v Capital Market Equities Limited* (1995) 7 NZCLC 260,718 at 21.

A market impact test was applied by the Commission in its Gulf Resources Report.[206] The Commission regarded the information[207] as "possibly" material. A temporary share price increase of approximately 7%[208] before the share price plummeted was considered reasonable grounds to hold the companies had inside information while purchasing shares prior to this.[209] It is important to note the finding of insider trading was based on the purchase of shares before the temporary increase, and regardless of the fact no actual profit was made due to the subsequent decline in share price.[210] On this authority even a temporary elevation or depression (as opposed to a long term trend) of the share price will be evidence of materiality. The Commission cited US authority to support that fluctuation in a company's share price after the release of potentially material information is not determinative of materiality.[211] The Commission cited a US case where a price movement after a subsequent release of information lacking, however this was not fatal to finding the information was material. Because the price movement in Gulf shares was minimal the Commission might have cited this authority to justify its finding of materiality despite the lack of a significant enough price movement. Conversely the Commission might have cited the authority to show it was not basing its finding of materiality on the share price fluctuation alone. Either way, this report suggests a small[212] price movement will meet the materiality standard under the market impact approach. Although a market impact test was clearly applied here, it is interesting to note the reference to US authority. If the Commission had expressly endorsed the *TSC* standard this could mean both qualitative and quantitative factors were to be taken into account. In support of this, cases that depend on qualitative factors are more likely to be ones where an obvious price movement is lacking. However as stated earlier, an

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[206] Securities Commission, *Report on Enquiry into Dealings in the Voting Securities of Gulf Resources Pacific Limited (Formerly City Realities Limited) During the Period November 1989 to January 1990* (June 1992).

[207] Securities Commission, *Gulf Resources Report,* above n 206, at paragraph 7.3. The information in question was information relating to the proposal discussion between representatives of two companies, Zelas and Rowland, to use another company CRL as a vehicle for the acquisition of commercial properties Gulf owned in New Zealand. Secondly the proposal that Gulf should take a controlling position in CRL, and thirdly, the knowledge that those persons who were in a position to influence CRL's acceptance of the proposal were receptive to it.

[208] This figure is based on the midpoint of range of share prices trading before and after the announcement.

[209] Securities Commission, *Gulf Resources Report,* above n 206, the Commission decided if the proposals were implemented, they could be perceived by the market to have an important effect on the administration of the company, on the quality of its assets, and on its net worth to shareholders.

[210] *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 Young QC's came to an opposite conclusion arguing a temporary fluctuation in the share price would not be significant as it would not affect the "affairs of the issuer". However Young's opinion was significantly overturned by the Court of Appeal.

[211] The Securities Commission cited *U.S.v. Bilzerian* (1991) Fed. Sec. L.R. 98283, 98290-98291. In *Bilzerian* the information was material despite there being no movement in the share price once the information was released to the market. "whether a public company's stock price moves up or down or stays the same after the filing of a Schedule 13D does not establish the materiality of the statements made, though stock movement is a factor the jury may consider relevant." *U.S.v. Bilzerian* (1991) Fed. Sec. L.R. 98283, 98290-98291 at 1298.

[212] This 7% increase is low because of the spread of prices at which the shares were trading. While the midpoint increased by this percentage, the range moved from 40 and 45, to 48 to 50 then back to 43 – 48 cents in three days. Arguably such a price movement is more a result of speculative buying or selling as will be discussed further below.

approach that does not require a minimum effect on the share price would render the word "material" superfluous. Another consequence of expressly adopting *TSC* would be the lowering of the materiality standard to include information that does not necessarily induce the investor to change his or her actions (for example voting or buying or selling).

In *Wilson Neill* the court clearly favoured a market impact test to establish materiality. The CA stressed that "price sensitive" actually meant "price material".[213]Although the CA clarified that a "bare possibility" of a price movement was not enough to come within the meaning of "likely" preferring a "real or substantial risk",[214] this did not clarify the significance of the price movement required.

The influence of a market impact test was also evident in the Commission's Regal Salmon Report.[215] In this report the news of a loss of $3.36 million "took the market by surprise"[216] and the share price dropped from 147 cents to 115 per share[217] (a movement of approximately 22%) and eventually traded as low as 72 cents. The Commission held there were material overstatements, according to accounting standards, in the financial reports prior to the report that caused the share price drop.[218] Despite this the Commission found Shagin, the director who had sold shares after the release of this materially overstated report, did not possess material information because he had not undertaken a skilled analysis of the data.[219]

The market impact test was once again dominant in the Commission's Fortex Report.[220] The Commission took account of the drop in the share price of 43 cents to 7 cents following the

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213 *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 161.
214 *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 161 "a real and substantial risk is required".
215 Securities Commission, *Regal Salmon Report,* above n 50.
216 Ibid.
217 Ibid.
218 The Securities Commission was using the materiality standard in accounting SSAP No 6 *Materiality in Financial Statements* (revised 1985) affirmed by the Accounting Standards Review Board in a release of 10 November 2000 (release of ASRB Release 7 *Accounting Standards that Still have Authoritative Support Within the Accounting Profession* (issued 11/00). This standard for materiality was "A statement, fact, or item is material if, given full consideration of the surrounding circumstances at the time of the completion of the financial statements, it is of such a nature that its disclosure, or the method of treating it, would be likely to influence the making of decisions by users of financial statement".
219 See above chapter 1, "Possession of Information".
220 "We consider the question whether information would have been price material is best answered by market experts. The question as we see it is how significantly share analysts would have reduced the value attached to Fortex shares if they had learnt prior to 11 March of the information." Securities Commission, *Report on an Inquiry into Aspects of the Affairs of Fortex Group Limited (In Receivership and Liquidation) Including Trading in Its Listed Securities* (October 1995) at paragraph 12.19.

announcement of a 40 - 45 million dollar loss.[221] Among the information analysed was the fact of the appointment of an independent investigation accountant, Mr Stiassny. This had been communicated to Fortex's farmer suppliers. On this information the Commission commented, "We think that news of an appointment of such a person in such a position might also have acted as a signal to investors that all was not well with Fortex." The Commission only went as far as saying this was potentially price sensitive. It is unclear what "test" of materiality the Commission is using. However the reference of "signal to investors" perhaps indicates a reasonable investor standard. The Commission also looked at the fact the company had lost 16% market share, saying "a number of variables exist that leave unclear the question of how the market would react to this information. Was the loss of market share recoverable? How significant was the loss of market share given that the supply of lambs in the season to date had been well below what Fortex had expected? How sensitive to market share did other share analysts consider Fortex's profit to be?"[222]

In *Haylock*[223] the market impact test was clearly influential although once again it is difficult to ascertain a threshold for the degree of impact necessary. When assessing the materiality of the information[224] Gault P stated "it will be difficult to contend that the information would not have been price-sensitive when the receipt of new licenses for un-investigated areas was seen as justifying an increase in the price offered for the shares".[225] Gault P accepted that there are difficulties with respect to disclosure in the gas and exploration industries. He stated "that may bear heavily on aspects of the claim, for example any assessment of loss involving notional disclosure would need to take account of the reservations or qualifications that would be necessary to ensure only appropriate impact on share values. The lure of hindsight, often attractive to claimants, must be resisted."[226] This indicated a clear willingness to look at share price impact to measure materiality and recognises that only the movement in share price attributable to the information itself should be taken into account.

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[221] Securities Commission, *Fortex Report,* above n 220, at paragraph 3.6.
[222] Ibid at paragraph 12.21.
[223] *Southern Petroleum v Haylock* [2003] 3 NZLR 518.
[224] In *Southern Petroleum v Haylock* [2003] 3 NZLR 518 the undisclosed information consisted of four points; That the commercial prospects of the Managahewa gas resource had reached the point where the value of the SPNL shares were much higher Haylock (at paragraph 21). Specifically that the evaluation of the Mangahewa structure within the license area being bigger than Maui. The identification of the Mangahewa structure as suitable for the use of new technology, and the evaluation of the probability of the commercial success of the venture being at the highest level on accepted industry standards, and recommendations the drilling commenced in March 1996. This information was contrasted with what the shareholders knew, that the prospects of the area being commercially successful for drilling were the normal level for this type of industry.
[225] *Southern Petroleum v Haylock* [2003] 3 NZLR 518 at paragraph 63.
[226] *Southern Petroleum v Haylock* [2003] 3 NZLR 518 at paragraph 67.

In the Commission's Fletcher Challenge Report,[227] the information was a draft press release revealing the information that "FCL management were considering options for a possible merger of FCL Paper with Fletcher Challenge Canada".[228] On materiality the Commission commented: "it seems clear that an announcement that a company is considering a major restructuring of one of its divisions is likely to materially affect the price of the shares of that division. This is so whether the release is known to be a draft document or a final news release, and whether there has been speculation in the market on these matters. An authoritative statement from within FCL on the subject would be an important event."[229] This analysis arguably puts weight on the source of the information (the fact that it was a draft from within the company) highlighting its increased reliability. The Commission also looked at the subsequent price movements of FCL shares.[230] After a halt on trading due to the leakage of the information, the share price peaked at 13% higher than when trading restarted, before dropping to a level 6% higher than at the start of the trading halt. The price then dropped sharply on 11 May at $1.68 (2.3% below the level before the trading halt). The Commission found this effect to be material. Clearly this was based on a market impact test.

In *Midavia*[231] the Court displayed a clear preference for the market impact test stating "because much inside information, such as the issuer's results being unexpectedly better or worse than earlier publicly forecast- will rapidly become public and bring in its train an impact on the price of the issuer's securities".[232]

a) Conclusion

In *Wilson Neill*, and *Kincaid* the market impact test is clearly dominant and is preferred over evidence based on standards that are more akin to a "reasonable investor" analysis. This is further supported by the Commission's reports into Gulf Resources, Regal Salmon, Fortex. The

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227 Securities Commission, *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999,* Insider Trading Law and Practice (20 November 2000)

228 Securities Commission, *Fletcher Challenge Report,* above n 227, at paragraph 19.

229 Ibid, at paragraph 102.

230 The week of 26 to 30 April saw FCL Paper share prices rise on very heavy trading from around $1.43 at the start of the week to close the week on $1.67 (a rise of around 17% in 5 days). The following week the price rose to $1.75 before falling back to around $1.72 at 2 pm on Friday 7 May. Ibid, at paragraph 56; after the release of the leaked page to stockbrokers at 2 pm on the Friday the price of these shares began to rise further. The price peaked at $1.94 at around 10 am on Monday 10 May (a rise of about 13% in a little over 2 trading hours) before dropping to close at $1.82 (up 6% on the 2 pm price for 7 May). The price continued to drop sharply on 11 May, closing at $1.68. Ibid at paragraph 58.

231 *Securities Commission v Midavia Rail Investments BBVA* [2007] 2 NZLR 454.

232 *Securities Commission v Midavia Rail Investments BBVA* Unreported, High Court, Auckland, CIV-2004-485-2174, 28/9/05, Williams J at paragraph 86.

more recent statement by the Commission in the Fletcher Challenge Report further enforces the dominance of market impact as they were able to conclude materiality on a temporary, arguably equivocal, share price movement. The most recent New Zealand insider trading cases, *Haylock* and *Midavia*, provide little discussion of materiality however statements of the courts seem to take for granted the appropriate approach is “market impact”. Regardless of the approach taken by the courts to materiality, the cases do little to resolve the two important thresholds that are common to all materiality tests, the significance threshold and the reliability threshold.

B. THE MARKET FAIRNESS APPROACH

The market fairness approach represents the idea that all participants in a market should have equal access to information about a public issuer.[233] Fairness is important due to the flow on economic effects in the market. If investors feel the market is unfair the flow on effect is a decrease in the amount of money people are willing to invest, therefore an increased cost of capital.[234] "So long as insider trading serves as an indication of the character of the securities market, "fairness" is likely to have economic consequences through the reaction of investors and must be taken into account in any attempt to predict or enhance the market's efficiency".[235]

The market fairness rationale is evident in the Australian legislation. The focus of the sections is the possession of material information by anyone in the market. [236] The sections do not require an inside trader to be connected to the company.[237] Importantly the Australian sections do something the New Zealand SMAA does not: it defines materiality by reference to the reasonable investor. On what constitutes information "likely to have a material effect", the Australian section 1042D of the Corporations Act reads:

> A reasonable person would be taken to expect information to have a material effect on the price or value of securities of...financial products if (and only if) the information would, or would be likely to, influence persons who commonly acquire...financial products in deciding whether or not to acquire or dispose of the first mentioned financial products.

1. *Materiality under the market fairness approach*

The approach to materiality under the market fairness rationale utilises a combination of the three tests: reasonable investor, market impact, and magnitude/probability. However the method used is not made explicit by the Courts. One recurring feature is the absence of any sensitivity to the different types of information that can arise. As a result the materiality analysis is much cruder than the analysis in the US. Also in a couple of instances the obvious choice of test (for example the probability/magnitude test where information is forward looking) is ignored and reliance on significant share price movements used instead.

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233 Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at 15; Michael Gething, 'Insider Trading Enforcement: Where Are We Now and Where do We Go From Here?' (1998) 16 *Company and Securities Law Journal* 607 at 608.

234 Insider trading has the capacity to undermine the integrity of the market in public securities and for that reason is an offence that is viewed as serious, see *R v Doff* [2005] NSWCCA 119 at [56] and *Regina v Rivkin* [2004] NSWCCA 7.

235 Anisman, above n 97, at 9.

236 Australia's current insider trading provisions are found in Div 3 of Pt 7.10 of the Corporations Act 2001 (Cth). They are a substantial re-enactment of Div 2A of Pt 7.11 of the former Corporations Law.

237 Lyon, above n 67, at 16.

The reasonable investor approach is present in the background of all the cases due to the wording of the materiality definition. However, the courts do not seem content to rely on the reasonable investor test alone, using the market impact or magnitude/probability tests to supplement it. Many cases equate the reasonable investor test with "price sensitivity". This indicates that the Australian courts' view the reasonable investor test as more restrictive than the wide approach of the US courts where qualitative information can be included. For example in *Ampolex,*[238] Rolfe J said "one must ask whether such a reasonable person would expect that the intention, being an intention of persons who hold a parcel of the convertible notes to so advise the ASX could or would be likely to influence the designated persons"[239] but then Rolfe J equated this requirement with "price sensitivity" returning to a market impact analysis.[240] In *Ampolex*[241]the allegations of insider trading arose in the context of a wider dispute about the conversion rate to be applied to convertible notes issued by Ampolex. The information in this case was the intention to advise the ASX that an application had been made by GPG to convert certain convertible notes at a ratio of 6.6:1 when the general market perception of the relevant conversion rate was 1:1.

In *Evans v Doyle*[242] the material information was the test results of mineral exploration. Mt Kersey Mining NL held licenses to mine the land adjoining where the test results had discovered a shoot of high-grade nickel sulphide.[243] The discovery was significant in the mineral grade, but was un-quantified. However, the discovery suggested the minerals extended onto the company's land. This information falls squarely within the category of soft predictive information. The outcome of the information on the fortune of the company was uncertain despite its potential to be significant. Evidence was admitted to illustrate the impact of the information on the price of the shares once the information was disseminated.[244] Surprisingly on facts broadly similar to *Texas Gulf* in the US,[245] there was no attempt to analyse the information in terms its probability/magnitude. The Court ignored the subtleties of the types of information that can occur in favour of market impact evidence.

[238] *Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd* (1996) 20 ACSR 649 at 1523.
[239] *Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd* (1996) 20 ACSR 649 at 1523.
[240] *Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd* (1996) 20 ACSR 649 at 1523.
[241] *Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd* (1996) 20 ACSR 649.
[242] R *v Evans & Doyle* [1999] VSC 488 (15 November 1999).
[243] R *v Evans & Doyle* [1999] VSC 488 (15 November 1999). The location of the discovery about 950 metres west of tenements in respect of which Mt Kersey Mining NL had made applications for mining leases, 2 km east of tenements in respect of which Mt Kersey Mining NL had exploration leases, and north of tenements in respect of which Mt Kersey Mining NL had made application for mining leases.
[244] R *v Evans & Doyle* [1999] VSC 488 (15 November 1999) at 548.
[245] S*EC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).

Rivkin[246] was the first prosecution of an "outsider" under a market fairness regime and illustrated how "materiality" would operate where there was no connection to the company.[247] Mr Rivkin wished to sell his house, and instructed a real estate agent, Doff to act on his behalf. Mr McGowan, Executive Chairperson of Impulse Airlines was interested in purchasing the house. He approached Doff and eventually spoke to Rivkin in a phone conversation on 24 April 2001 in which he revealed information about his company's affairs. He explained to Rivkin he wished to make the purchase conditional as he was waiting to "merge" businesses with Qantas. Rivkin expressed disbelief that the company's would get the necessary regulatory approval, but was reassured by McGowan. Further McGowan warned Rivkin he could not now trade in the Qantas shares. Following the conversation Rivkin purchased 50 000 Qantas shares. On 1 May 2001 on Rivkin's instructions the shares were sold making a profit of $2664.94. Later that day the merger was announced and there was a significant rise in the price of Qantas shares.

Rivkin established that the source of information can be included in the information itself.[248] It was argued that the information possessed was not the actual state of affairs conveyed but was the fact that Mr McGowan had stated that such a state of affairs existed. This was rejected because it was held a person need not believe the underlying state of affairs to be true (the essence of the argument against including this information). The Court considered a number of expert opinions that expressed the source of the information would be crucial to its reliability and therefore its materiality:[249] "It was also abundantly clear that the circumstance that Mr McGowan was the source was relevant to the question of the reliability of the information, and hence its materiality."[250] The Court seemed to be applying the reasonable investor test. However there is a clear departure from the US materiality approach. In the US the question of the source of the information is distinct from materiality. For example, an outsider who receives the information from an insider is required to know that it is being disclosed in breach of confidence.[251] This requirement was expressly rejected in *Rivkin* as it was held there was nothing

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[246] *Regina v Rivkin* [2004] NSWCCA 7; see also *R v Doff* [2005] NSWSC 50.
[247] *Rivkin* has been labelled a "landmark case" by commentators as it is one of the few successful prosecutions of an outsider trader following a not-guilty plea. Overland, above n 54, at 709.
[248] *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 131: "what the appellant was in possession of was the state of affairs described and its source."
[249] *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 51: Graham Sellars-Jones, an experienced stock broker said an aspect of importance was its source as a judgment had to be made as to its reliability. "He pointed out there was a sliding scale of reliability, depending on how certain the person was as to its truth or untruth."; The Crown also called Nigel Littlewood as an expert who acknowledged that "if he (McGowan) had been the source it was relatively authoritative and would have been taken more seriously." *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 73.
[250]*Regina v Rivkin* [2004] NSWCCA 7 paragraph 137.
[251] *Chiarella v. United States* (1980) 445 U.S. 222.

in the legislation to suggest such a requirement.[252] This creates a challenge for materiality determinations as arguably there is now a third feature to analyse. Strangely the arguments to support this proposition were based on the idea that to allow such an argument would allow insiders to avoid the scheme where the source is reliable but a mere rumour was conveyed. It was acknowledged that the market "operated on matters of sentiment, rumour and tips"[253]therefore this type of situation should be covered by insider trading law. The main problem with such an assertion is that in most cases "sentiment and rumour" in the market contains only information that is generally available and therefore not material.[254]

Petsas[255] involved merger negotiations; however, unlike the US approach a probability/magnitude test was not expressly addressed. The information was confirmation of the existence of confidential merger negotiations between BRL Hardy Ltd and Constellation Brands, and confirmation that ANZ had been engaged by BRL to perform work in relation to this merger. The Court recognised "because of their tentative nature the discussions were highly confidential". However this "soft" quality of the information did not factor into the Court's materiality analysis. The Court stated "Mr Petsas and Mr Miot knew that if the information about the merger discussions became public it would affect the price of BRL's shares as well as the price of the call options over those shares."[256] Under the US approach this information would have also been material because Constellation Brands Inc is one of the world's largest producers and suppliers of alcohol. Because of its relative size, the existence of negotiations would be a significant fact to a shareholder regardless of the level of probability that they would eventuate into a merger. The US Court would have reached this conclusion by looking at the information from the perspective of a reasonable investor. However the Court skipped an analysis of this kind. The strong evidence of market impact made it unnecessary to elaborate. When the information was released the stock price rose immediately by around 17% and continued to rise.

Hannes[257]demonstrated a mixed approach to materiality equating the reasonable investor test with the market impact test. The Court summarised its approach stating:

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[252] *Regina v Rivkin* [2004] NSWCCA 7 paragraph 139.
[253] *Regina v Rivkin* [2004] NSWCCA 7 paragraph 72.
[254] The idea that the source of the information should be analysed at the "generally available" stage will be explored further below.
[255] *ASIC v Petsas & Miot* [2005] FCA 88; [2005] 23 ACLC 269.
[256] *ASIC v Petsas & Miot* [2005] FCA 88; [2005] 23 ACLC 269 at paragraph 7.
[257] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373.

> Materiality is concerned with investor conduct and, more particularly, with the question as to whether the particularised information would or would be likely to influence...(the reasonable investor). This might generally be said to be concerned with the capacity of information to influence investor behaviour which in turn, has a material effect on the price or value of securities. Accordingly, materiality is concerned with information which might be said to be price sensitive.[258]

The information on which the information was based in the charge was "it was likely that shares in TNT Limited would be the subject of a takeover at a price in excess of $2 per share." specifying merely a floor price at which the offer would be made.

Because of the way the information was particularised there was considerable objection to the use of evidence of the share price movement of the announcement of a takeover at $2.45. It was argued that the evidence of what actually occurred on the day of the announcement was information of a "qualitatively different nature" than the information particularised (the "possibility of a takeover at a price above $2.01"). When evaluating whether the particularised information was generally available the Court found "there is a difference for example, between speculation as to a "takeover valuation", on the one hand, and information as to the likelihood of a particular takeover, on the other. It was the combination of the information particularised which was significant in relation to the offence charged."[259] The Court held these differences did not mean the evidence of what actually happened was irrelevant to materiality.[260] The Court clearly favoured the evidence of share price movements over other evidence stating "The possibility that other factors may have affected the market for a particular security at a particular time must always be borne in mind, but to reject information as to price movements out of hand on that basis is at least to risk inviting the jury to speculate, without the assistance of the only concrete evidence of which might be thought to provide some assistance in undertaking that evaluation."[261] So despite the Court's recognition that it was applying a reasonable investor test it relied heavily on market impact evidence.

Significantly, in *Hannes* the Court was directed to US authority[262] in an attempt to limit the influence of evidence of share price movements.[263] However the Court felt there were two important points of distinction to be made. Firstly the US cases dealt with whether a failure to

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[258] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 384-385.
[259] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 382.
[260] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 299.
[261] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 351.
[262] *Reiss v Pan American World Airways Inc* 711 F.2d 11 (2d Cir. 1983); *Securities and Exchange Commission v Texas Gulf Sulphur CO* 401 F.2d 833 (2d Cir. 1968) at 863.
[263] Evidence of share price movements play a more limited role in the overall assessment of the US Courts when applying a reasonable investor test.

disclose was misleading (as opposed to an insider trading case) "an issue to which any increase in the value of the stock after disclosure was clearly not compelling".[264] Secondly the US cases only described the evidence as of "limited value" which is different from saying it has no probative value.[265] The Court commented, "it is readily apparent that the law in question in that case was a materially different form of insider trading prohibition to that with which the present charge is concerned, the reasoning nevertheless demonstrates that evidence of subsequent trading is treated in US law as potentially relevant to issues similar to that of "general availability" under Australian Law."[266]

In 2007, *Citigroup*[267] demonstrated the full dominance of the market impact test.[268] The information in question (for the second charge) was "knowledge of the timing" of the announcement of the takeover by Toll. This was in an environment where the market contained such a high degree of speculation that it knowledge of the "substantial likelihood" of a takeover was generally available. The only factor relied on to establish the materiality of the above information was a price rise between the close of trading on Friday and the opening price of the stock after the announcement had been made early Monday morning. This is clearly a market impact test.

a) Conclusion

The test adopted by the Australian courts seems to be predominantly market impact despite section1042D suggesting a reasonable investor test. From the heavy emphasis on the share price movements and the repeated references to price sensitivity, it seems that the information must be of a kind that would actually induce the reasonable investor to buy or sell shares thereby

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[264] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 352.
[265] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 352.
[266] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373 at paragraph 354.
[267] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.
[268] The first insider trading claim failed because Manchee was not considered an "officer" of Citigroup and was not found to have made the supposition contended. It was argued that after the "cigarette conversation" in which his supervisor told him not to buy any more Patrick shares, Manchee formed an "un-communicated supposition" that the rumours about the takeover were true and that Citigroup was acting for Toll. The court went on to analyse the "price sensitivity" of this information. It was held that at the time of Manchee's sale, the market had already moved the share price to a level that reflected "the substantial likelihood" of a takeover. The further non-public information that Manchee held, that Citigroup was acting for the Bidder, was not material. The second insider trading claim failed because an effective Chinese wall was in place. However the materiality analysis undertaken by the court reflected a pure market impact test. The information was the knowledge that Citigroup was acting for the Bidder, and the timing of the announcement of the takeover bid. Before the start of trading on Monday, the takeover was announced to the market. The court found it was likely knowledge of the timing of the release was material because the Patrick shares opened the day of the announcement at $7.19, 10.9% higher than the closing price the Friday before. This price rise, and the subsequent price rise to $7.38 alone seemed to establish the materiality of the information.

creating a price impact. The Australian courts do not address the possibility that information that would create an impact once released might not be recognised as such by a reasonable investor prior to its release.

Surprisingly the courts do not differentiate between hard, soft, or predictive information particularly information about mergers. This could be due to the heavy reliance on a price impact analysis, where, regardless of its nature before the announcement a price impact indicates its materiality after its release. The subtleties of information seem to have more relevance when analysing the deliberative process of the investor or shareholder under the US test.

Finally, there is no way to determine a threshold for the level of significance or reliability required for information to be material. This criticism is not isolated to the Australian approach as the US and New Zealand approaches were also incapable of setting such a threshold.

C. A COMPARISON OF THE TWO APPROACHES.

1. *Does the underlying rationale affect materiality?*

It is difficult to determine from the case law on this whether there is a difference in the approach to materiality under the two rationales. This is because often the cases that are acted on by regulatory bodies are reasonably clear cases of insider trading and "materiality".[269] Often the cases are accompanied by a sharp or significant movement in the share price after the information is disclosed. In most of the cases it is not necessary to find the lower threshold for materiality because it is easier for the courts to accept expert evidence supporting that the information is material. This causes the problem that the cases do not give insiders or outsiders any guidance on when they may trade on information, as they do not provide any guidance on how significant a price movement must be, or how reliable the information must be perceived to be, for it to be material. In effect it is a "gotcha" standard because it relies on *ex post facto* evidence.[270]

However some differences exist that have a bearing on materiality. The "reasonable investor" test has taken a slightly different form in Australia leading to a higher materiality threshold. In Australia, the source of the information plays a more significant role in determining the materiality of information leading to a complication of a materiality analysis. It is unclear whether Australia's version of the reasonable investor test has been imported by the SMAA that on its face seems to favour a market impact test.

Firstly, the threshold for materiality in Australia is more demanding than in the US because of the requirement the information would be viewed by the reasonable investor as likely to affect the share price.[271] At first it might be expected that in essence both tests are the reasonable investor test, therefore materiality should be the same. However the inclusion of the words "effect on price" in the Australian section (and consequently SMAA) is significant. It has led to the approach being closely aligned to a "market impact" analysis, as the courts have viewed evidence of share price movements as highly relevant and sometimes determinative. The US test focuses more on the deliberative process of the investor. It does not demand that the

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[269] *ASIC v Petsas & Miot* [2005] FCA 88; *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373.
[270] Unger, Laura, *Special Study: Regulation Fair Disclosure Revisited* (2001) available at http://www.sec.gov/news/studies/regfdstudy.htm (as at September 20).
[271] Corporations Act 2001 section 1002(1)(2).

information would have induced the investor to buy or sell but requires that it "assume actual significance" in the investor's deliberations.[272] Because the second limb of the *TSC* test refers to the "total mix" of information available, evidence of share price movements are admissible in the US but not determinative.[273] It has also been suggested by Cox that there is little difference in practice between the tests, but without evidence of more "hard cases" being determined by the courts in this area it is impossible to know.[274]

Secondly, one clear difference between the versions of the reasonable investor test is the inclusion or exclusion of qualitative information. The fact the US test potentially encompasses both qualitative and quantitative information means it is much wider than the Australian approach.

Thirdly, under the market fairness approach the source of the information blends into its materiality. It has been illustrated that the tests employed by the courts search for a threshold level of significance and reliability.[275] The two features together determine materiality. However *Rivkin* arguably adds a third element into the Australian analysis: reliability of the source of the information.

The importance of the source of the information is recognised in both fiduciary and market fairness regimes.[276] However under a fiduciary approach the "reliability" of the source of information is much more easily established. This is because the US cases all involve information that was sourced (albeit sometimes indirectly) from the company. The source of the information forms part of the threshold question of whether a duty exists: the trader needs to know that the information was received in breach of confidence to the owner of the information. This is particularly important in tippee liability. Because an insider knows they are already "inside" the company, and information that comes their way is probably reliable, it sends a clear signal to the insider to analyse the significance and reliability of the content of the information carefully. The materiality question is engaged after this initial determination of the source is made. As a

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[272] James D Cox, 'An Outsider's Perspective of Insider Trading Regulation in Australia' (1989-1990) 12 *Sydney Law Review* 455 at 470; *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 449.
[273] *U.S.v. Bilzerian* (1991) Fed. Sec. L.R. 98283, 98290-98291.
[274] Cox, above n 272, at 470.
[275] Very significant information can be material despite a low level of reliability (for example the existence of merger discussions). Alternatively very reliable information, with a low level of significance may well be material (for example a financial reporting error of 3%).
[276] A US commentator noted "The source and presentation of information may also influence its perceived reliability to investors. A report from an established analyst typically carries more weight with investors than a pseudonymous posting on an internet thread." Sauer, above n 179, at 322.

consequence the "reliability" element in the US focuses on the actual measurable probability of the information occurring and its verifiability.

On the other hand under market fairness approach the reliability aspect of the information is more difficult to deal with. *Rivkin* demonstrates the "source of the information" is included in the information itself. Under the market fairness approach information's significance is largely dealt with using a market impact method, by resorting to evidence of the likelihood of price movements and their magnitude as opposed to asking whether a shareholder would consider it important. Taking such an approach means an inclusion of the source of the information in the market fairness approach substitutes for the "connection"[277] under a fiduciary approach. Because under a market impact approach there is a much wider range of circumstances that information may be imparted to an investor the reliability aspect takes on a new dimension: it must also analyse the circumstances in which the information arose. This makes finding a threshold even harder.

If the source of the information is included there is a possibility information insiders may elevate themselves to tippers where the bare information would not have been material. The facts of *Citigroup*[278] demonstrate this risk. An employee of a large investment bank speculates (forms an uncommunicated supposition) that his investment bank is working on a merger of two companies. There is already a large amount of speculation in the market that the two companies will merge to the point the market is relatively certain the event will take place in the near future. The identity of an advising firm would not by itself provide any additional significant information to the market because, by itself, it does not confirm the firms will in fact merge only reasserts what is generally available that it is likely the firms will merge (and with that it is certain they will both have a firm acting for them). However if the employee conveys this supposition to someone, the fact it is information from within the advising firm arguably elevates his speculation about the identity of the advising firm to a material fact and therefore is guilty of tipping. His own possession of that information would probably be unlikely to tip the balance of information in the market. Under a fiduciary regime the fact it came from within the firm would establish it was a breach of confidence, then the focus would be on whether or not the confirmation that that particular firm was acting for one of the parties was sufficiently significant

[277] Loke, Alexander F, 'From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore' (2006) 54 *American Journal of Comparative Law* 123.
[278] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.

to alter the total mix. However under a market fairness regime the source and the information are combined. The fact that it is from an "inside source" appears to concrete the reliability of the information and therefore makes it more likely the information will be material.

2. *The interaction with the "generally available" limb of inside information*

The source of the information is often an indication of whether the information is generally available. Under a fiduciary approach the source would relate to whether the tippee knows that the information is being communicated in circumstances that constitute a breach of duty. If the source and circumstances of receiving the information does not go to the availability of the information how can this be determined? Overland gives the example of three examples of information:

- A press release addressed to the ASX and signed by the company secretary of ABC Ltd which states that ABC Ltd is about to launch a takeover bid for XYZ Ltd.
- A statement from a trusted stockbroker that he has heard that ABC Ltd is about to launch a takeover bid for XYZ Ltd.
- A statement overheard whilst walking in the street that a passer-by's brother has heard that ABC Ltd is about to launch a take-over bid for XYZ Ltd.[279]

Overland argues if you imagine a person overhearing the above information it becomes clear that the source of each piece of information forms a vital part of the information itself.[280] Without the inclusion of the source, each piece of information seems identical. However an alternative approach would be to look at the information as identical, but at different stages of availability: the first being clearly not generally available and the third probably common knowledge.

Overland commends the development in *Rivkin*. She argues speculation and rumour can have an impact on the price of securities and so people acting on rumour or speculation should also be caught by the regime.[281] However a criticism can be made of this position. The real damage caused by rumour or speculation is where it comes from an insider in breach of his or her duty to the company. Where, for reasons of commercial sensitivity, the information has been kept confidential such a tip could cause damage to the company's plans and therefore its current shareholders. However, sometimes rumour or speculation in the market (and trading on it) can be a good thing. If extensive enough to have an impact on the share price, speculation is usually

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[279] Overland, above n 54, at 716.
[280] Ibid, at 716.
[281] Overland, above n 54, at 716.

"generally available", particularly where it has not originated from the company. In a number of cases "rumour" in the market has been admitted as evidence of what information was generally available.[282] Trading on such information often improves the accuracy of the share price meaning that official announcements often have a smaller impact on the share price than if there had been no leakage of the information. This reduces the opportunity for "real" insiders to take advantage of the information. Often rumours are the result of market analysts piecing together industry factors with the specific circumstance to accurately predict what might occur. *Citigroup* is a clear example of this as a high degree of speculation and rumour created by a number of objectively observable circumstances moved the share price.

[282] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.

CHAPTER THREE: MATERIALITY: AN OBSTACLE TO COMPLIANCE AND ENFORCEMENT

New Zealand has a poor record of insider trading enforcement.[283] A lack of enforcement does not necessarily indicate a low level of insider trading: it can only be speculated to what extent the regime is actually complied with. Materiality is one of the factors that prevent a more rigorous enforcement of the regime. Materiality is also arguably an obstacle to compliance with the regime. Company insiders need to trade for a number of legitimate reasons, for example to diversify their assets or to convert remuneration in the form of shares in the company into capital.[284] It is suggested due to the difficulties in determining from an insider's point of view, whether something is material, more often than not the prohibition is ignored by many insiders and other market participants. The New Zealand Business Round Table ("NZBRT") stated in its submission on the Bill: "If businesses are expected to pay for clarifying rulings or interpretations, some may be commercially driven to fly blind and risk technical non-compliance."[285] As a result the purpose of the insider trading law is frustrated.

A. MATERIALITY AS AN OBSTACLE TO COMPLIANCE

1. *Efficiency, behavioural finance and the market impact test*

Underlying the Courts' reliance on the market impact test is the idea that the market is efficient.[286] Because the market is efficient, share price movements are an accurate measure of the significance (therefore materiality) of new information. Broadly put the Efficient Markets Hypothesis (EMH) means that share prices already reflect all available information about the value of that share.[287] Therefore, because a share price already reflects all available information

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[283] In Australia from 1985 to 2005 only 14 people have been tried for insider trading in Australia, of whom 10 were found not guilty (*R v Martin* (Unreported, District Court, WA, 1 August 2003; *R v Kruse* (Unreported, District Court, NSW, 2 December, 1999, O'Rielly J, 98/11/0908); *R v Firns* (Unreported, District Court, NSW, 4 Nov 1999, 98/11/0895); (2001) 51 NSWLR 548; [2001] NSWCCA 191 (convicted at trial but overturned on appeal); *R v Evans & Doyle* [1999] VSC 488;

[284] Macey, Jonathan R, Miller, Geoffrey P, Mitchell, Mark L and Netter, Jeffry M "Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson" *Virginia Law Review* 77 (1991) 1017 at 1017.

[285] New Zealand Business Round Table, *Submission to the Ministry of Economic Development on the Reform of Securities Trading Law* (2002) http://www.nzbr.org.nz/documents/submissions/submissions-2002/insider_trading.pdf (at 16 September 2007) at 7.

[286] Walker, Fisse, and Ramsay, above n 79 at 607.

[287] Imagine that you could predict that Telecom was going to rise from its current price of $4.66 (the last recorded price at 11.37am on 17 July) to $6.00 in two days time (for example because of knowledge that Telecom will be

its price should only decrease or increase in response to the entrance of new information in the market.[288]

2. ***Trying to establish materiality using a market impact test***

In many cases, courts rely on expert evidence to establish that the information would have had a material effect on the share price if it had been generally available. In cases where the information is disclosed, the courts also rely on the evidence of the actual share price movements. At first sight this suggests that it should be relatively easy to distinguish material information from immaterial information. However at least one author provides a clear indication that even with a high level of knowledge about the way the market reacts, this determination is not an easy, or even possible, one without the benefit of hindsight. Alister Alcock stated:

> In my 11 years as a corporate financier working for a large broking house, the most common question I was asked before the announcement of a deal was "What will happen to the share price?" the truthful answer usually was "I don't know". Substantial purchases or sales could be seen as cheap or dear, as strengthening the company's prospects or weakening them, as making further share issues more or less likely. Prosecutors have the advantage of knowing the outcome.[289]

If an experienced corporate financier is unable to predict what will happen on the disclosure of information, how then can the "reasonable person" be expected to do so? It has already been established the law is not clear on who this reasonable person is. But even on the assumption that the sophisticated investor is the appropriate hypothetical person, it is clear that analysing materiality based on *ex post* share price movements provides no adequate guidance to insiders or outsiders who must decide whether to trade.

Another problem exists with the market impact test; it uses *ex post* price movements to establish the *ex ante* knowledge of the reasonable investor. However in *Citygoup*[290] there seemed to be an

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undertaking a successful acquisition). Immediately people will attempt to buy Telecom in order to capture the gain expected over the next two days. However because the information is already generally available those holding Telecom shares will not sell for less than 6.00. Therefore the price, that is determined by the buy and sell prices of investors, immediately rises to 6.00 today (this would be the lowest price at which a rational person would sell their shares).

[288] Donald C Langevoort, 'Taming the Animal Spirits of the Stock Markets: a Behavioural Approach to Securities Regulation ' in John Armour and Joseph A McCahery (eds), *After Enron: Improving Corporate Law and Modernising Securities Regulation in Europe and the US* (2006) 65 at 70.

[289] Alistair Alcock, 'Inside Information' in Barry Rider and Michael Ashe (eds), *The Fiduciary, the Insider, and the Conflict: a Compendium of Essays* (1995) at 89.

[290] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA.

unwillingness to attribute the same "benefit of hindsight" to knowledge held by the market generally. When evaluating the expert evidence offered in *Citigroup* as to what information was held by the market generally, the Court held that the information available was "more persuasive after the event than it apparently was on 19 August 2005."[291] Further the Court stated: "Although Mr Harvey acknowledged that the absence of a report from Mr Smith may have triggered some of the activity in Patrick shares, this was a clue that was only available with the benefit of hindsight."[292] It seems extraordinarily inconsistent to give the market the benefit of the doubt as to whether the information was available, but to allow share price movements to be evidence of the "extra information" held by the insider.

The market impact test also seems unable to specify a minimum threshold of the level of price movement required to establish materiality. This problem is exaggerated by the small size of the New Zealand market.[293] Even if the direction of the movement of the share price can be predicted, the courts have not provided a minimum threshold for the magnitude of the share price movement. In a relatively illiquid market such as New Zealand, a large trade can move the share price up or down through price impact.[294] If no minimum threshold is provided, an institutional trader's knowledge that it is about to purchase a large block of shares could, on the market impact test, be material information. The NZBRT submissions on the market manipulation regime support this proposition describing how it is common for brokers to break up large orders to avoid price impact.[295] The practice of managing large orders in this way is evidence that large orders can create price impact. Prosecution for insider trading on such facts is unlikely[296] but it highlights a serious flaw in the market impact test as it is currently applied. If a market impact test is to be applied a minimum threshold price movement must be specified.

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[291] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963 at paragraph 557.

[292] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963 at paragraph 562.

[293] Bart Frijns, Aaron Gilbert, Alireza Tourani-Rad, "Insider Trading, Regulation and the Components of the Bid-Ask Spread" available at http://www.fma.org/Stockholm/Papers/Insidernbid-askspread.pdf (at 20 September); "The New Zealand Exchange is one of the smallest and least liquid, developed market around the world."; Bhattacharya Utpal and Hazem Daouk, 'The World Price of Insider Trading' (2002) 57 *The Journal of Finance* 75.

[294] Bodie, Kane, and Marcus, above n 40.

[295] "Because of the low liquidity, it is commonly efficient for intermediaries (brokers) to manage large orders over several days in order to reduce the impact on the market of executing the order. The concealment of the existence of that order from competing dealers could well fall under any definition of market manipulation. The practice reduces market volatility and transaction costs. It is both efficient and desirable." New Zealand Business Round Table, *Submission to the Ministry of Economic Development on the Reform of Securities Trading Law* (2002) http://www.nzbr.org.nz/documents/submissions/submissions-2002/insider_trading.pdf (at 16 September 2007) at 11.

[296] As it would probably fall under the knowledge of one's own intentions exception in section 9C SMAA.

3. ***Further complication: behavioural finance theory and market impact***

The market impact approach relies heavily on efficiency. However efficiency is a contestable concept in modern securities markets. Langevoort explains an irrational market reaction in response to media attention. On Sunday 3 May 1998 an edition of the New York Times ran a story about Entremed, a Biotech company that held licensing rights to a medical breakthrough. As a result of the increased media attention caused by the article the share price rose dramatically.[297] Langevoort reveals this article contained no new information, everything had already been disclosed in previous Times articles and company releases. Therefore, the share price increase directly contradicts the EMH theory that share prices immediately impound all available information.[298]

Behavioural finance theory stems from the idea that market participants are influenced by psychological factors, not just fundamental values.[299] Where investors play the game of second guessing what other investors will do, the traded share price can stray from its fundamental value. The problem this raises for materiality is that it is not clear whether the tests assume investors make decisions based on fundamental value or whether the tests allow room for this speculative element.[300]

Commentators have reflected this uncertainty without explicitly recognising the link to the behavioural finance theory. The market reaction to information has been labelled too crude to reflect a hypothetical reasonable investor's reaction: "holders of a small amount of a company's securities may have different priorities than institutional investors and thus react differently to particular corporate developments. That holders of a small number of company's shares do not act in numbers sufficient to affect stock prices does not make their views unreasonable....Given that the great bulk of securities transactions are now made by institutional investors, to say otherwise would make the "reasonable investor" synonymous with the well-funded money

[297] Langevoort, above n 288, at 70.
[298] Ibid.
[299] Langevoort, Donald C, 'Theories, Assumptions and Securities Regulation: Market Efficiency Revisited' (1991) 140 *University of Pennsylvania Law Review* 851at 866. Keynes hypothesised that investors in the market played a game similar to one being played in newspaper beauty contests at the time he wrote. Readers voted for the most attractive contestant and the winners of the pool came from those who voted for the entrant who received the most votes. Therefore the readers' strategy was to try and guess who would receive the most votes, instead of basing their decision on who was the most attractive. A decision based on who is the most attractive is likened to a fundamental analysis of stocks where an investor evaluates the financial position of the company and its future opportunities and bases his or her evaluation of the share price on these factors. Therefore, provided the investor has all the relevant information for making this assessment there is an equilibrium or rational price of the share.
[300] Ibid, at 866.

manager."[301] If all investors reacted in an economically rational way to information arguably sophisticated, unsophisticated, large, and small investors would react the same way but it is clear they do not. Richard Sauer highlights a well known bias that investors react disproportionately to a change in news:[302]

> Even when a company's disclosure is, clear, complete, and can be isolated from all background noise, market reaction may not provide a perfect measure of its materiality. The very event of a corrective disclosure of a previous misstatement, for example, may seem more significant to investors than the substance of the disclosure if the disclosure gives rise to investors' fears of civil or criminal liability or it is suspected to be the first instalment of what will likely be a series of escalating abd news items.[303]

Another example of behavioural finance at work is the phenomenon of price momentum.[304] Simplified this is the theory that good or bad recent performance of particular shares continues over time without any new information being released to the market. This defies the EMH claim that subsequent price movements are independent of their antecedents.[305] For example in the instance good news is released to the market, a slow upward trend in the share price following the announcement suggests the initial reaction was an under reaction and the price is slowly adjusting. An instant but excessive reaction leading to a downward trend suggests the initial response was an overreaction.[306] This is called the overreaction phenomenon.[307] If these factors are not taken into account when using a market impact test there is significant potential for unfairness if an investor cannot predict the severity of the market's reaction.

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[301] Sauer, above n 179, at 325.
[302] Bodie, Kane, and Marcus, above n 40.
[303] Sauer, above n 179, at 325.
[304] Narasimhan Jegadeesh and Sheridan Titman, 'Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency' (1993) 48 *Journal of Finance* 65.
[305] Langevoort, above n 288, at 72.
[306] Ibid.
[307] Ibid, at 72. The overreaction effect has arguably been evident in share price movements relied on in several instances to establish materiality. For example in Securities Commission, *Report on Enquiry into Dealings in the Voting Securities of Gulf Resources Pacific Limited (Formerly City Realities Limited) During the Period November 1989 to January 1990* (June 1992) found evidence of a settling in the price of the shares after the initial announcement. The shares rose briefly from a 40-45 cent range up to a 48-50 cent range, then fell to a 43-48 cent range two days after the announcement. Arguably the overreaction effect could have been relevant to an assessment of how significant this information actually was; Securities Commission, *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999,* Insider Trading Law and Practice (20 November 2000) revealed a price fluctuation possibly explained by the overreaction effect: The Commission found that the leaked page did in fact have a material effect on the price of Fletcher Challenge shares. After the release of the leaked page to stockbrokers at 2 pm on the Friday the price of these shares began to rise. The price peaked at $1.94 at around 10am on Monday 10 May (a rise of about 13% in a little over 2 trading hours) before dropping to close at $1.82 (up 6% on the 2 pm price for 7 May). The price continued to drop sharply the next day, closing at $1.68.

Citigroup[308] provides a good example of where reliance on EMH theory might lead to a flawed measure of the materiality. The 10.9% increase in the share price over the weekend could have been explained by a momentum effect of the information that was generally available on the Friday; that there was a "substantial likelihood" of a takeover. If so, the price movement is unreliable evidence of the materiality of the knowledge of the timing of the announcement because it might be a result of this momentum effect not the release of the timing of the announcement.[309] In such circumstances it is difficult to define the extent to which the release of the information caused the further decline/increase in the shares value, as opposed to a general trend in the price due to the momentum effect.

An economically irrational overreaction could magnify the appearance of materiality; to the extent even a seemingly insignificant piece of information may cross the (unknown) materiality threshold. This is an alarming possibility. For an insider to profit off such information, the insider would need to know the content and the exact time and date at which it the information would be eventually released. If information is good but insignificant news, the insider would need to buy shares on the knowledge that there would be an overreaction and he or she could sell in the period of the "bubble" in the price before it returned to its rational level. While this is a remote possibility, it is unclear how the reasonable person would be able to employ such a strategy.

Despite the increasing recognition of behavioural finance, the courts in Australia and New Zealand tend to ignore the other possible causes of share price movements when determining materiality.[310]Anomalies in the reaction of the market are not within the knowledge of the average investor. If the courts continue to use price movements to establish materiality of information they must begin to expressly recognise these anomalies and accommodate them. It is too much to ask that the average investor know of these anomalies therefore a strong case

[308] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963.

[309] *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 153, the market was "increasingly losing confidence" and the price of Wilson Neill shares had been falling. It continued to fall after the announcement of the cancellation of the put option in July. The market price had fallen to 30 cents before an announcement on 20 September 1991 of further losses for the 15 months ended June 1991. By the end of 1991 the shares were worth 10 cents; Securities Commission, *Report on Questions Arising from an Inquiry into Trading in the Shares of Fletcher Challenge Limited in May 1999,* Insider Trading Law and Practice (20 November 2000) at paragraph 103.

[310] *Midavia* displays reliance on traditional EMH principles stating "Because much inside information, such as the issuers results being unexpectedly better or worse than earlier publicly forecast- will rapidly become public and bring in its train an impact on the price of the issuers securities". *Securities Commission v Midavia Rail Investments BBVA* Unreported, High Court, Auckland, CIV-2004-485-2174, 28/9/05, Williams J at paragraph 86.

exists to limit the application of such a test to insiders who possess a higher degree of knowledge of the market.

4. *The removal of "approved procedures"*

Insiders need to trade frequently for a number of legitimate reasons.[311] Under the SMA insiders could trade within "approved procedures".[312] Therefore, if they were doubtful of the materiality of the information (as most cases prove is inevitable) there was a safe harbour to use in order to trade. Under the SMAA this exception has been removed. Therefore uncertainty of the materiality of the information will undoubtedly require the prudent insider (and outsider) to abstain from trading.[313] Therefore determinations of materiality assume heightened significance in determining whether insiders can trade.

[311] Securities Commission, *Regal Salmon Report,* above n 50, Shagin had argued his sale of a share parcel of 550 000 shares was to purchase a house.
[312] SMA section 8(1). The procedure allowed trading despite the existence of inside information if a) the trading was done in the insiders name b) the trading was within procedures adopted by the issuer designed preventing insider trading.
[313] SMAA section 8.

B. MATERIALITY: AN OBSTACLE FOR ENFORCEMENT OF INSIDER TRADING

The cases do not display a clear threshold of the significance or reliability required for materiality. This is an obstacle to enforcing insider trading as regulatory bodies are only going to follow up and pursue clear cases. This is supported by Gething who suggests three main problems that face ASIC in trying to prosecute insider trading.[314] These are: the difficulty of detection, the problem of proving knowledge, and the necessity to rely on expert evidence to prove materiality.[315] Similarly Tomasic lists the "materiality" issue as one of nine obstacles to enforcement of insider trading.[316]

Cox argues that the American prosecutions for insider trading have not been hindered by findings that the information was not material.[317] He argues that the essence of insider trading is the fact that the trader has in fact profited from the trading, and argues that no prosecution has been initiated against the bumbling insider trader.[318] Several commentators have related the success of insider trading enforcement in the US to its less technical anti fraud provision.[319]

[314] Gething, above n 233, at 618.
[315] Ibid, at 618.
[316] Roman Tomasic and Brendan Petony, *Casino Capitalism?: Insider Trading in Australia* (1991) at 121.
[317] Cox, above n 272, at 470.
[318] Cox, above n 272, at 470. He states "certainly in America inside traders make money and one would expect this to be true elsewhere".
[319] Tomasic, Roman, "Corporate Crime: Making the Law more Credible" (1990) 8 *Company and Securities Law Journal* 369 "The excessively legalistic language of some of corporate and securities legislation has been an open invitation to corporate crime."

C. HOW THE FIDUCIARY CONNECTION REDUCES OBSTACLES TO ENFORCEMENT AND COMPLIANCE

A market fairness rationale creates an over inclusive insider trading regime that puts greater pressure on a materiality standard that is already difficult to apply and enforce. It forces materiality to assume a greater role in "sorting" illegal insider trades from legitimate trades. The Australian experience shows this is done for little gain. In Australia only one person who could be considered a true outsider has been convicted of insider trading.[320] Even in that case, Rene Rivkin was really an "insider" of the wider share market community in Australia.

The fiduciary connection reduces obstacles to enforcement and compliance by accommodating a lower materiality threshold.[321] It is suggested this lower threshold is acceptable in a fiduciary situation because the insiders have knowledge of their privileged position in terms of access to specially informed information. The insider has been given a signal about the potentially significant quality of any information obtained in this position. Because for an employee (insider) under the US "disclose or abstain rule" full disclosure of information is not a viable option, the rule amounts to the requirement the employee, completely abstain from trading. Langevoort stated: "that seems acceptable given that the position of the Court seems to be that classical insiders should not trade based on informational advantage gained as a result of their corporate positions."[322] This idea is equally applicable to New Zealand and justifies a more onerous restriction on insiders through a fiduciary approach.

Conversely, the market fairness approach increases obstacles to enforcement and compliance because it necessitates the use of a law that all market participants can follow and understand. For a materiality standard to be effective it must be accessible to even the most unsophisticated investor. There has been a complete refusal to adopt "bright line" rules on which people can base their trading decisions. It has been demonstrated that the unsophisticated investor has a limited ability to deal with the subtleties of price movements. It seems unfair to impose an ambiguous rule on the whole market for the sake of catching, in most cases, company insiders. A trade off must be made between adopting a stringent rule setting materiality at a low threshold for insiders under a fiduciary approach and allowing some outsiders to trade without

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[320] *Regina v Rivkin* [2004] NSWCCA 7.

[321] This has been demonstrated in chapter 2 where it was found the US "reasonable investor test" includes qualitative information and does not require the information to have an ostensible effect by changing the recipient's course of action.

[322] Langevoort, Donald C, 'The Muddled Duty to Disclose Under Rule 10b-5' (2004) 57 *Vanderbilt Law Review* 1639 at 1659.

consequences. Gething suggests the source of the information will usually be the company.[323] If this is correct, a prosecution under the market fairness approach should usually include at least one charge that would have been caught under the fiduciary regime anyway.[324]

It has also been demonstrated that the courts in one way or another, put a gloss on materiality: that information is to be understood from the perspective of the sophisticated investor. Under a fiduciary regime such a gloss is more appropriate as the test's application is limited to insiders who are likely to have a greater understanding of the operation of financial markets.

Materiality under a fiduciary regime can be more carefully measured because an analysis of the "source" is kept separate from materiality. A fiduciary regime removes the extra complication that a person must judge how reliable the reasonable person would view the source.

What is most important in an insider trading regime is boosting investor confidence. The perception that insiders are unjustly enriched by inside information has been labelled "corrosive".[325] Arguably the general public are not as offended by the idea that someone who stumbles across inside information by chance (for example the fax in the Fletcher Challenge Report) might make a profit. The perception that real insiders are the people the law should target is bolstered by cases such as *Midavia*[326] that highlight the dodgy dealing of high profile insiders such as David Richwhite. Although the Commission claimed the settlement with David Richwhite over the trading in Tranz rail shares was a success,[327] many would argue such a result does not achieve the purpose of the insider trading regime. For one thing the deterrent effect is limited in a settlement that does not require the traders to admit their culpability. Promotion of confidence in the market is arguably not promoted by such a settlement.[328] With this in mind the law should make it easier to enforce against those insiders not harder. As Stephen Franks suggested, instead of being extended the law should be more ruthlessly enforced.[329]

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[323] Gething, above n 233, at 618.
[324] SMAA section 8D.
[325] Saikrishna Prakash, 'Our Dysfunctional Insider Trading Regime' (1999) 99 *Columbia Law Review* 1491 at 1500.
[326] *Securities Commission v Midavia Rail Investments BBVA* [2007] 2 NZLR 454.
[327] Jane Diplock, "Regulating Insider Trading Effectively: Lessons From New Zealand", *25th Cambridge International Symposium on Economic Crime*, Jesus College Cambridge, September 2007, http://www.seccom.govt.nz/speeches/2007/jds070907.shtml?print=true (at 15 September 2007).
[328] Tomasic and Petony, above n 316.
[329] Franks, Stephen 'Parliament Must Tidy Up Primitive *New Zealand Herald*, 5 December 2000. Available at http://www.nzherald.co.nz/feature/index.cfm?c_id=729 (at 10 September 2007).

D. DO INSIDER TRADING LAWS MATTER?

So far it has been demonstrated that there is a divergence in the underlying rationales for regulating insider trading in the US, Australia and New Zealand. It has also been suggested that materiality is easier establish in a legal setting under a fiduciary approach similar to the one taken in the US. This matters because it if materiality is easier to establish enforcement and compliance with the regime will be easier.

This is important because the existence of insider trading laws does not matter unless they are enforced.[330] There is strong evidence to suggest that insider trading laws only have an effect on the cost of capital in a market (a good measure of confidence in the market) where they are enforced.[331] Also empirical evidence exists suggesting that countries with more stringent insider trading laws have more dispersed equity ownership, more liquid stock markets, and more informative stock prices.[332] However the stringency of the laws is irrelevant without enforcement. Therefore barriers to enforcement must be minimised to ensure insider trading laws reduce the cost of capital in New Zealand. If the law does not achieve this arguably the costs of compliance with this difficult standard will outweigh the benefits.

A fiduciary regime that requires a relationship to the company to be established and then adopts a low materiality threshold will be more effective than a market fairness approach. A carefully crafted safe harbour can be used to allow the insiders to trade when necessary. While this approach puts a heavy burden on insiders and severely limits their ability to trade it is a necessary consequence of holding a position that provides privileged access to information.

[330] Utpal and Daouk, above n 293, establish that the cost of capital in a country is not reduced by the existence of insider trading laws, but is reduced when they are enforced. "Whichever approach we use, we find that insider trading enforcement is associated with a significant decrease in the cost of equity. The numerical estimate of this decrease in the cost of equity ranges from a low of 0.3 percent ~the credit rating approach! to a high of 7 percent ~the international asset pricing model approach. More importantly, we find that the mere existence of insider trading regulations does not affect the cost of equity."
[331] Ibid.
[332] Laura Nyantung Beny, 'Insider Trading Laws and Stock Markets around the World: An Empirical Contribution to the Theoretical Law and Economics Debate' (2006-2007) 32 *Journal of Corporation Law* 237 at 239.

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