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SEMINAR AUCKLAND NEW ZEALAND 26 JULY 1996

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FROM ACROSS THE TASMAN

I have always liked New Zealand. In rash and callow youthful days, I even reminded its citizens (and Prime Minister Muldoon) of the covering clauses of the Australian Federal

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* Justice of the High Court of Australia 1996-. Formerly Chairman of the Australian Law Reform Commission (1975-84); and President of the New South Wales Court of Appeal (1984-96). Fellow of the New Zealand Legal Research Foundation.

Constitution which contemplated that New Zealand would become a member of the Australian federation[1]. The people of New Zealand yawned and the Prime Minister exploded. But life went on much as it had done.

The Closer Economic Relations (CER) Treaty has continued to do its work, binding our economies and their institutions together in ways that are proving more firm than even advocates of political association might once have expected. One of the blessings of federation is said to be the opportunity for legal experimentation in jurisdictions which are basically very similar, but which can learn from each other as to what law works and what law does not. Even without federation, the Australian and New Zealand legal systems are sufficiently alike, and our institutions sufficiently familiar, to permit us to study each other's laws with advantage. We can dismiss the variations with cynicism and self-satisfaction, if we will. But yoked as we are by geography, history, economic relations and by the common law tradition, we will do well, at least in areas of economic and business law, to increase the surveillance and enhance, where relevant and appropriate, the commonalities of our approaches.

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1 M D Kirby, "Closer Economic and Legal Relations Between Australia and New Zealand" (1984) 58 *ALJ* 383.

At the same time, each of us will do well to study the experience of other countries of like history, legal institutions and economic arrangements. These include not only the traditional sources of legal ideas in the United Kingdom[2], the United States of America[3], and Canada[4]. Conscious of our newly perceived geographic opportunities, we should also be looking to the experience of nearer neighbours with lessons to teach us, notably Malaysia and Singapore[5] whose economies continue to expand most rapidly, accompanied (relevantly) by major growth in the securities industry.

When I was invited to take part in these seminars, I was assigned my topic with the injunction that my discussion should address some of the "philosophical and policy dimensions" of the debate about insider trading: including of the debate about statutory regulation as against non-regulation or self-regulation.

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2 eg B Hannigan, *Insider Trading*, Kluwer, London, 1988.

3 eg H Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*, Harcourt Brace, New York, 1979 at 32ff; L Loss, *Fundamentals of Securities Regulation*, Little, Brown and Co, Boston, 1983 at 684.

4 D L Johnston, *Canadian Securities Regulation*, Butterworths, Toronto, 1977 at 275.

5 Tan Boon Teik, "Regulation versus Self-Regulation in the Securities Industry" in 9th Commonwealth Law Conference, *Conference Papers*, 1990 at 191.

Someone tender to my new obligation of discretion as a Justice of the High Court of Australia, alerted me to the fire and heat which had been observed at the New Zealand law conference in Dunedin earlier this year when the topic of regulation of the securities industry came up for debate. The last thing that I would wish to do would be to become embroiled in a New Zealand controversy about the shape of laws and policies to deal with the issue of insider trading in this country. I have forsworn my earlier constitutional ambitions, hopeful that the invisible hand of the market will achieve, in time, as much inter-relationship of Australia and New Zealand as their peoples desire. In any case, as to political association, the phenomena of globalisation and regionalisation which have come upon the world with such power since the earlier grand visions of federation across the Tasman, have perhaps made issues of national political and constitutional association less important than formerly they were. However, it is not for me to be, or to appear to be, offering advice to the government, the regulators or the people of New Zealand on how their securities industry should be governed. That is purely the business of New Zealand.

When my anxiety about the topic was communicated to the organisers, I was assured that the *Securities Amendment Act* 1988 (NZ) had been in force for eight years. Whilst there were differing views as to the desirability, utility and effectiveness of the rules and procedures laid down for insider trading, it was "not exactly a hot topic" in New Zealand. Even the discussion

paper issued by the New Zealand Securities Commission on insider trading in September 1995[6] appeared to have attracted "little interest". Reassured by this intelligence and by the typically polite, restrained, even genteel debates about the topic in the New Zealand media, law reviews, court reports and other material which I saw, it seemed safe enough to indulge once again my affection for New Zealand and to cross the Tasman. Assigned as I am to philosophical and policy questions, I can safely venture remarks at that high level of generality that has come to be expected of judges in ultimate courts of appeal. There will be something for all. And the result will be that none are satisfied.

THE NEW ZEALAND SETTING

It is not my province to describe in detail the New Zealand, Australian or any other system for regulation of the securities industry in general or insider trading in particular. But it may be helpful, to set the scene, to indicate in very general terms the stage reached in the New Zealand debate.

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6 New Zealand Securities Commission *Insider Trading*, Discussion Paper, 1995. See A Beck and A Borrowdale, *Companies and Securities Law*, CCH, Auckland, 1990 at 363-369.

The first statutory prohibition against insider trading was enacted by the *Securities Amendment Act* 1988 (NZ). By the Act, members and former members of a public issuer, and the public issuer itself, were given the right to commence an action against a person who is an insider of the public issuer, either for trading on the basis of inside information or for tipping (or encouraging) others to trade[7]. The public issuer is provided with a right to apply to the court for an order that an insider is liable for a pecuniary penalty[8]. This liability may be the greater of three times the profit made, or loss avoided, by the insider or the total consideration paid or received by the insider. The Act empowers the Court to determine how the penalty will be distributed[9].

In order to work these provisions, a typical problem of enforcement of the law is presented. Some people devote their entire lives to the study of the effectiveness of law enforcement, including in the field of corporate conduct[10]. The debate

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7 *Securities Amendment Act* 1988 (NZ), ss 7(1), 9(1).

8 *Id*, s 7(2)(c)(ii) and 9(2)(g).

9 *Id*, s 19.

10 See eg B Fisse and J Braithwaite, *Corporations, Crime and Accountability*, Cambridge, 1993; B Fisse and P A French, *Corrigible Corporations and Unruly Law*, Trinity Uni, San Antonio, 1985 at 185.

concerning self-regulation and public regulation is as old as the corporation itself, indeed older. In the field of market regulation and the debates about the establishment and work of a national securities body, the controversy was particularly vigorous in the United States of America in the late 1930s. It was given voice in the exchanges between the New York Stock Exchange and the chairman of the Securities and Exchange Commission, Mr (later Justice) William O Douglas[11].

There is also a debate, which has been vigorous in New Zealand, concerning the relative merits of criminal as against civil sanctions to enforce rules against insider trading. An earlier report of the New Zealand Securities Commission recommended in favour of civil remedies as "the best method of preventing insider trading ... [by] equip[ing] companies and shareholders with the legal rights and powers to detect and deal with it"[12]. The Commission concluded that overseas experience had taught that criminal prosecutions were difficult in the face of the "right to silence". Their existence could sometimes interfere with attempts to take civil action to require the profiteers to disgorge their advantages.

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11 Loss, above n 3, at 685.

12 New Zealand Securities Commission *Insider Trading - Report to Minister of Justice* 1987, vol 1 at 95.

Associated with the debate about the relative roles of criminal and civil sanctions has been a controversy concerning the respective functions of (i) individual shareholders (acting for company and shareholders generally); (ii) the company itself; and (iii) a public regulatory body such as, in New Zealand, the Securities Commission. Each of these players was thought to have a relevant function in sanctioning impermissible insider trading. The matter of debate was usually the respective function which each of them would fulfil in order to make the prohibition effective and to give teeth to it.

Initially the New Zealand Securities Commission toyed with the idea of relying on the company unaided to bring action in the interests of the shareholders as a whole. This sounds good in theory. However, the practical problems, which the Commission acknowledged, are demonstrated by the pre-existing law and experience. All too often those "insiders" who have taken advantage of insider information (or persons connected with them) are the very persons who have control of the company, or are close to those in control. They are therefore often unlikely to be in the forefront of enthusiastic prosecution of the claim for disgorgement or defence of the nebulous "interests of the company as a whole".

This sensible and practical conclusion led to the quandary of determining the respective roles of the state regulator and

individuals who were, or had been, shareholders with sufficient standing to initiate the proceedings for disgorgement. In the past, when there was, perhaps, greater faith in public regulatory institutions to uphold socially sanctioned behaviour, the normal solution would have been to appoint a Crown agency as regulator and to provide it with funds and staff sufficient to ensure that the policy of the law was upheld. For various reasons, the New Zealand Commission did not favour this approach, nor did the New Zealand Parliament[13]. I do not presume to list all of the reasons. They include the general retreat away from state regulators; the disharmony of the idea with market de-regulation; the costs involved in state regulation; the perceived undesirability of mixing the advisory functions of the Securities Commission with regulatory and prosecutorial activities; the potential which such a regulatory body presented to intrude unduly in the marketplace, and in legitimate corporate activity;. and the perceived undesirability of authorising a state instrumentality to intrude in the marketplace in effect to protect the personal economic interests of individuals who were not pursuing their own interests but leaving it to the community, spending taxpayer's money, to do so.

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13 The story is told in P Fitzsimons, "Enforcement of Insider Trading Laws by Shareholders in New Zealand: An Analysis and Proposals for Reform" (1995) 3 *Waikato Law Rev* 101 at 104ff.

It was this general conclusion that led to the establishment of the peculiar New Zealand arrangement found in ss 17 and 18 of the 1988 Act. I say peculiar because, although all legal systems deriving their approach to corporate regulation, ultimately, from England and the common law, permitted derivative suits by shareholders, New Zealand put unequalled faith in such private initiative, by or on behalf of shareholders, to enforce the prohibition on insider trading.

It is for those with greater knowledge than I possess to say whether this act of faith in individual self-interest and initiative has proved justified. However, the general opinion of legal commentators, and the ultimate opinion of the Securities Commission itself, seems to be that the system has not worked well and is in need of reform. The ultimate question before this seminar is the direction which that reform should take.

Mr Peter Fitzsimons, in a recent essay in the *Waikato Law Review*[14], concludes that the 1988 Act was predicated on shareholders playing a significant part in either taking actions or encouraging public issuers to take actions against insider traders.

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14 *Loc cit.*

He is of the opinion that insufficient attention was paid by the lawmakers to the means by which such actions would be funded. Inadequate study was made of the provision of incentives, protection and advantages needed to stimulate such actions. Excessive impediments both of a legal and practical character were placed in the way of the initiation of such actions as demonstrated by the very few cases that have come before the New Zealand courts[15]. Unsuitable procedures governed sensible and just settlement of such actions. For these and other reasons, the system had failed to achieve the sanctioning effect for which it was ostensibly designed:

> "Unless serious consideration is given to enhancing the ability of shareholders and the Commission to take action against insider trading, it is likely that New Zealand will continue to have laws that prohibit insider trading, but which are unenforced and therefore ineffective"[16].

The Securities Commission itself obviously shares some of those views. But it has drawn back from a proposal, in earlier discussion papers, that it should finally take on a regulatory and prosecutorial function, similar to that carried out by other national securities industry agencies. It has disclaimed a

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15 See eg *Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR at 152 (CA).

16 Fitzsimons, above n 13, 125.

significant criminal prosecutorial power. Instead it has addressed proposals for reform with a number of limited and highly specific ideas which are now before the New Zealand community for consideration. These include:

* To extend the definition of "insider" in the Act to include employees of related parties of public issuers;

* To clarify the application of the regime to the insider's spouse or child;

* To permit a lawyer, appointed for the purpose of considering the actionabilty of a suit against insider trading, to consult with the Commission; to withhold privilege against defamation in respect of the publication of the advisory opinion of the lawyer consulted on the actionability of the alleged insider trading;

* To empower the High Court to approve settlement of insider trading claims to ensure that those who prosecute them are not bought off to the disadvantage of other shareholders or the company and that the interests of all shareholders are weighed;

* To make specific provision in relation to costs to facilitate such actions;

* To provide for a more flexible power of prohibition on the management of companies by those found guilty of insider trading; and

* To introduce a more stringent test, with objective criteria, for the "Chinese wall" exception which is available as a defence to a claim of insider trading[17]

Of course, the answers to the questions posed by the Commission's discussion paper will eventually be given. Decisions upon the foregoing proposals, and their adequacy, will in due course be made. It may be hoped that the discussion at these seminars will be a contribution to these issues. But before the answers are given, it is important to reflect on a number of fundamental issues which it is my function to call to notice. These include the empirical data on the extent of "insider trading", however it is defined; the need for regulation at all; and, once it is decided that regulation is both desirable and feasible, the comparative advantages of the various kinds of regulation that have been used to tackle the problem, as defined.

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17 New Zealand Securities Commission, above n 6, 12-14.

EMPIRICAL DATA

Ten years of service in the Australian Law Reform Commission taught me that legal regulation likely to work must be founded upon as good an understanding as it is possible to get of the nature and extent of the problem, carefully defined, to which the law is to be addressed. All too often incompetent lawmaking arises from the failure of the lawmaker to understand sufficiently what it is that is being addressed, the extent of the social problem which is being targeted and the differential value of alternative sanctions and remedies that are available to achieve the defined goal. Legislation is drafted quickly. An urgent cry goes out to provide a solution to a particular problem. Editorialists demand action. Commentators express concern. Ministers dragoon their officials into urgent activity. Lo and behold a statute is drawn up. In New Zealand, you do not even have the Standing Committee of Attorneys-General or a second parliamentary chamber to apply the brakes (sometimes in Australia for too long) to allow mature reflection, public consultation, political agitation and the working of democracy. Suddenly, an Act of Parliament is born.

So long as there has been a securities market, there has been the misuse of position, breaches of fiduciary duties to companies, losses by shareholders and the public and demands (when these events are revealed) for harsh penalties and

intrusive regulation. At the beginning of the eighteenth century, Daniel Defoe, observing the trading in stock wrote:

> "Some in clandestine companies combine, erect new stocks to trade beyond the line, with air and empty names beguile the towns and raise new credits first, then cry them down, divide the empty nothing into shares and set the crowd together by the ears"[18].

In Australia, the stock market crash of 1987, and the many revelations of greed, excesses and criminality of the 1980s produced a plethora of inquiries, investigations, Royal Commissions and other activities addressed to the failed companies and the wrong-doers and how they had been able to escape with so much money belonging to other people. The result was a call, often encouraged by the general media at least, for more legal regulation to deal with such miscreants and to bind them up with rules designed to prevent such rorts and crashes in the future[19].

The result of these developments, at least in Australia, has been the enactment of extremely complex laws. The new laws

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18 D Defoe cited in R Schoer, "Self-Regulation and the Australian Stock Exchange" in P Grabosky and J Braithwaite (eds) *Business Regulation and Australia's Future*, AIC, Canberra, 1993, 107 at 108.

19 *Ibid*, 108.

have not gone without criticism. The former Chief Justice of the High Court of Australia, Sir Anthony Mason, in 1991 said[20]:

> "The vast magnitude of our corporations legislation is a wonder to behold. Its Byzantine complexity is a testimony to the subtlety of mind of those who brought it into existence ... Complexity, inconvenience, delay and high costs, so often the targets of media criticism, may indicate that our approach to legal regulation and enforcement requires overhaul."

The desirable criteria for a rational approach to the regulation of the securities industry were stated by the Attorney-General for Singapore as involving the provision of a market for securities which allows individuals and institutions to participate in the ownership and control of enterprises; gives a boost to the economy by attracting foreign portfolio investment in lieu of the less desirable direct foreign investment; and utilises resources of the state in such a way as best promotes the allocation of resources and prevents unacceptable abuses[21].

Every country with a securities industry, at least since the great Wall Street crash of 1929, has been struggling to define

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20 A F Mason, "Corporate Law: The Challenge of Complexity" (1991) 2 *Aust J Corp Law* 1. For a case of insider trading which reached the High Court of Australia see *Chew v The Queen* (1992) 173 CLR 626.

21 Tan Boon Teik, above n 5.

and then implement the desirable mix of self-regulation (harmonious to the nature of the particular market) and public regulation (designed to respond efficiently and with precision to frauds and abuses where they are proved).

The basic quandary is that of preserving, in the context of the securities industry, the element of freedom that is necessary to light the spark of entrepreneurship and to promote risk-taking in a context in which some activities are simply unacceptable and have to be regulated for the greater good.

For every proponent of further regulation in this area, there are vigilant supporters of caution and restraint. Thus Justice Brandeis of the United States Supreme Court cautioned against over-zealous legislation in the field of securities urging that "we must ever be on our guard lest we erect our prejudices into legal principles"[22]. President Roosevelt, explaining the objectives of the *Securities Exchange Act* 1933 (US) told the United States Congress:

> "The purpose of the legislation is to protect the public with the least possible interference to honest business. It is but one step in the broad purpose of protecting investors"[23].

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22 Cited *ibid,* at 192.

23 *Loc cit.*

Similarly the Kimber Report on the Canadian securities industry, in 1966, explained the search for the proper balance in these terms:

> "While the underlying purpose governing the practice and operation of the securities market must be the protection of the investing public, it is equally true that the character of securities legislation will affect the development of financial institutions and their efficiency in performing certain economic functions. Securities legislation must be designed not only to serve the purpose of reducing the imperfections of the free and open capital market but also to assure the efficient operation of the market in achieving long-term economic objectives".

The ambivalence reflected in the foregoing remarks can be easily explained. Elected representatives want the freest possible securities market that will attract funds, promote economic investment and thereby contribute to employment, growth and the human happiness that keeps electors, in democratic societies, content with their governors. They recognise that the initial brilliant idea of the corporation involves the taking of risks with other people's money on condition that the law will endeavour, with minimal interference, to uphold the fiduciary duty owed by the directors of a corporation to the interests of the company as a whole. The introduction of excessive regulation, binding those directors with the kinds of Byzantine rules which Sir Anthony Mason described above, are precisely the disincentives and obstacles to the achievement of economic goals of the corporation that have led in recent times

to increasing demands for the withdrawal of governmental regulation and a farewell to Byzantium. Yet these demands, in turn, produce a hue and cry when what are seen as instances of abuse of position and misuse of privileged information selfishly enrich the *few* where those involved were duty-bound to devote themselves to the interests of the *many* (basically shareholders, employees and the other proper objects of corporate interest).

Whether it is in the field of laws and policies addressed to an efficient response to the HIV/AIDS epidemic, industrial relations or the perceived problems of insider trading, the task for the rule-maker is essentially the same. Laws and policies must be based not upon hunch, guess-work, prejudice, instinct or the seat-of-the-pants feeling so congenial to many politicians and most lawyers of the common law tradition. To be effective, laws and policies must be based upon sound empirical data. Yet this is rarely the way in which our lawmaking proceeds.

Leaving aside for the moment the precise definition of insider trading, and accepting that it involves the sale or purchase of securities by someone who possesses information that is material to the price of the securities which are traded, which is not already know to other traders in the market (and is not the product of analysis of publicly available information by that trader), a question arises as to how widespread this practice is. Unless we know this, we may be wasting our time in devoting our attention to the issue or treating it as a problem

when it is not. Of course, it must be recognised that the nature of insider trading means that often it will be covert. Its practitioners will endeavour to cover their tracks. They will hide their activities, conceal their links: trying to make their profits or reducing their losses secretly. Yet observers of the market can reach conclusions about the scope of the "problem". Professor Robert Baxt and his colleagues have stated[24]:

> "...[T]he results of research into the extent of insider trading in Australia are somewhat inconclusive. Tomasic and Pentony concluded that the precise extent of insider trading cannot be quantified; that the level of insider trading is probably slightly lower than in the period prior to its prohibition by legislation; that insider trading occurs predominantly, but not exclusively, in lower level stocks; and that insider trading is more likely to be undertaken by persons associated with the relevant company. Tomasic and Pentony also found that insider trading generally took place in the market for shares rather than for options; and was frequently related to takeover activity. The weight to be given to these conclusions may be limited by the fact that the underlying research methodology is open to criticism".

Self-evidently, the extent of insider-trading, if it is a problem, is not disclosed by the number of cases that come before the courts on the prosecution of a securities agency. Still less, in New Zealand, is it demonstrated by the extremely small number

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24 R Baxt, H A J Ford and A J Black, *Securities Industry Law* (4th ed) Butterworths, Sydney, 1993 at 293.

of shareholders' actions which have navigated the impediments of knowledge, enthusiasm, cost, legal technicality, corporate obstruction and comparative lack of inducement to bring to court proceedings under ss 17 and 18 of the New Zealand Act.

If the path to wisdom is an appreciation of the scope of the problem, the first cautionary remark is that we should be striving to define with greater precision what it is that we are concerned about and how widespread that activity is in practice. We may criticise the methodology of Professor Tomasic and his colleagues. But our criticism would ring truer if we were to put in place a better methodology and conduct effective empirical research of our own. Scientific precision in this area is impossible. The nature of the problem makes that inescapable. But it seems remarkable that we have continued to address the issue of insider trading as a problem with such rudimentary raw data on the extent of the practice, the nature of its variable manifestations and the precise ways in which we think it has been inimical to society and specifically to the socially beneficial operation of a securities market.

Even if we were forced back upon anecdotal data to supplement such empirical information as we could secure, attention to the variable manifestations of "insider trading" would help us more precisely to define what it is that we are upset about and what features of it we wish to proscribe. Once this task was completed it would be possible to target, with

greater precision, those activities which may be suitable for stern statutory sanctions and those which could be left to self-regulation or to statutory derivative actions brought by shareholders and the company.

Instead of adopting this scientific approach to legislation, we have been content in our various jurisdictions to muddle along in the same old way. Some appealing to the criminal law and some not. Some invoking an energetic public agency; and some not. In New Zealand a prohibition exists upon the activity, narrowly defined. But there is then a sanctioning mechanism whose chief merit, in the eyes of some, seems to be that it does not cost much; does not arise often; and when it does is generally blown away by the winds of costs, delay and lack of incentive.

BUT IS IT A PROBLEM?

Perhaps the New Zealand approach is congenial to this country because of factors peculiar to it. For example, one commentator has suggested that, because New Zealand is a society with a relatively small population and securities market, conflicts are inevitable and insider information is often almost

impossible to avoid[25]. To this consideration, peculiar but not unique to New Zealand, must now be added technological considerations which make it more difficult than ever to contain the flow of information and, for some, undesirable to attempt to do so. Notions that, in a given corporation, one can prevent the spread of insider information from one part of the organisation to another by the creation of a glass partition as a "Chinese wall" or even the isolation of an investment floor from a trading floor are entirely naive. Employees meet each other in the lift or the lunch-time sandwich shop or on the bus home. It is a hundred years since they have been linked by telecommunications. Now to the telephone and fax must be added E-mail and the information super highway. In such circumstances, partitions of glass or physical impedimenta are almost completely ineffective. If the will to integrity is not there and enforced, Chinese walls (however defined) will rarely if ever be impenetrable. That does

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25 See commentary "Chalkie Differentiates Chinese Walls and Fortune Cookies" in *The Independent*, 10 November 1995, at 44; B Gaynor, "Securities Commission, NZSE Trade Blows on Insider Trading" *National Business Review*, 6 October 1995; F O'Sullivan, "Award of Costs Major Obstacle" in *National Business Review*, 6 October 1995 at 4; M Ziegelaar, "Insider-trading Law in Australia" in G Walker and B Fisse, *Securities Regulation in Australia and New Zealand*, OUP, Melbourne, 1994 at 677. The author categorises several types of insider trading including: classic insider trading; "front running"; "scalping"; "piggy-backing"; and "inside market information"; cf *Mallesons Stephen Jaques v KPMG Peat Marwick and Ors* (1991) 4 WAR 357 (Ipp J).

not mean that self-regulation should abandon the attempt to instil proper, responsible and ethical conduct. Nor does it mean that the law should entirely withdraw sanctions which define and uphold such conduct and provide redress where its rules are breached. But it does mean that we should recognise the limits of the law. And that we should attempt to state with exactness what it is that is concerning us before we attempt to regulate it[26].

There are writers who suggest that concern about insider trading is misconceived. Professor Henry Manne in his well-known essay "In Defense of Insider Trading"[27] sets the tone with his assertion[28]:

> "In the entire literature of insider trading there does not exist one careful analysis of the subject. Lawyers have been having a field day arguing about the meaning of words or the reach of the last case or any of a thousand technical and legal issues. Unfortunately, however, most lawyers do not have the skills to develop a careful economic analysis of the subject, and economists have offered no assistance. The tone of the debate has remained

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26 Kripke, above n 3 at 295.

27 44 *Harvard Bus Rev* 113 (1966). See also R A Posner and K E Scott, *Economics of Corporation Law and Securities Regulation*, Little, Brown and Company, Boston, 1980 at 130.

28 *Loc cit.*

> essentially moralistic and question-begging. Logic has been totally lost to emotion ..."

Manne's assertion is that, far from being an antisocial practice which should be the subject of detailed and even criminal sanctions, insider trading, from an economic point of view, is positively beneficial. It ought not to be prohibited.

Although the New Zealand Parliament, like the legislatures in Australia, the United Kingdom, the United States of America and Canada has rejected this notion and come down on the side of prohibiting insider trading (variously defined) it is perhaps an explanation of the ambivalence about definitions and sanctions, and the adoption in the case of New Zealand of sanctions which have been described as "unenforced and ineffective"[29] that we have not clarified effective answers to Manne's provocative suggestions. Thus, there is no entirely coherent definition of who is the actual victim of the insider. This has led to the suggestion that this is yet another victimless crime[30].

Most insider trading takes place in impersonal, anonymous stock exchanges where it is virtually impossible to establish a

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29 Fitzsimons, above n 13, 125.

30 Hannigan, above n 2 at 7.

relationship between the "insider" and the "outsider" other than that they happen to be in the same market at the same time[31]. Manne points out that the vendor has chosen, without inducement of the insider, voluntarily and quite independently of anything that the insider does, to enter the market and to sell the securities in question. True it is, it is not done on a level playing field. The insider has more information. But the "outsider" has acted according to a view of its own best interests. It is presumably content with the sale that it achieves. Such non-disclosure as provides the information deficit in the decision, is typically the result of actions of the company or of other "insiders". Upon this view, the "insider" trader has done a favour to the market by bringing forward the information more quickly than it otherwise would, thereby contributing, at an earlier time than otherwise would have been the case, to the achievement of a realistic market value for the securities in question. This is why critics of insider trading regulation even go so far as to describe such activity as beneficial to the market, believing as they do that the goal of "market egalitarianism" is completely unrealistic, at least as an absolute goal[32]. The insider, according to Manne, helps to move prices in the right

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31 *Loc cit.*

32 *Ibid*, 9.

direction towards a level which correctly reflects all of the real facts about the securities in question. To this extent, its activities ensure that the capital resources are properly allocated with minimum delay.

This thesis is stated in order to test our propositions and prejudices about insider trading, in the context of a renewed faith in the market economy and free enterprise. Reflecting upon such criticisms makes us justify the existence, extent and form of various regulations prohibiting insider trading. I have not done full credit to Manne's thesis. Those who design insider trading regulations must certainly read and consider it.

For myself, I consider that the thesis can be adequately answered. Professor Schotland noted, in a review of Manne's writings[33]:

> "Even if we found that unfettered insider trading would bring an economic gain, we might still forego that gain in order to secure a stock market and intracorporate relationships that satisfy such non-economic goals as fairness, just rewards and integrity".

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33 T Schotland, "Unsafe at Any Price, A Reply to Manne, Insider Trading and the Stock Market" 53 *Va L Rev* 1425 (1967). Cited Hannigan, above n 2 at 13-14.

Other commentators have put it more bluntly, if somewhat emotionally[34]:

> "... We do not let Paul rob Peter merely because he may be able to put the stolen property to a better economic use".

Still other commentators have pointed out that the statutory regulation of insider trading is simply a modern response to the law's insistence on enforcing fiduciary duties, redress for abuse of confidence and unjust enrichment. These duties are not, as such, concerned with economic imperatives alone. They are concerned with intangible notions such as honesty, duty of faith, fidelity in the use of other persons' money and information, and holding profits secured out of an advantageous office supposedly for the benefit of those for whose interests the office was created in the first place.

Even such proponents of the free market economy as Professor (now Judge) Richard Posner and Professor Kenneth Scott[35] are not wholly taken in by Manne's views. They ask[36]:

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34 Jennings, "Book Review", 55 Calif L Rev 1229 (1967) at 1234.

35 Posner and Scott above n 27 at 154.

36 *Loc cit*.

> "...[D]oes Manne skip too quickly over the possibility that insider trading would reduce managerial incentives to perform well, by enabling them to profit from an unexpected decline in the value of the company? If the managers knew that the company was, perhaps, because of their mismanagement, about to suffer a substantial loss not discounted in the market price of its stock because not yet known to the market, couldn't they (in the absence of any legal barriers) make handsome profits by selling the stock short? In short, wouldn't insider trading give managers an incentive to produce unexpected fluctuations in market value of their companies' stock rather than to maximise the present value of their companies?"

These are fair questions. Yet it is important to address Manne's criticism of any regulation in the area of insider trading. Only by doing so will we come to define with greater exactitude the conduct which we classify as unacceptably antisocial and the subcategories of that conduct which we believe should attract the intervention of the law, as distinct from moral denunciation, public editorials and the other passage of information in society which may ultimately help shareholders to know honourable corporate conduct from that of others who seek, when tempted, to feather their own nests.

DESIGN OF REGULATION

What, then, of the design of regulation to cope with the antisocial conduct, as defined? For a long time this has presented the dilemmas of governmental regulation versus self-

regulation and, within governmental regulation, of the varying kinds of regulation on offer.

As to the first quandary, it is still useful to call to mind what William Douglas wrote back in 1937[37]:

> "Ideally, of course, it would be desirable to have all national securities exchanges so organised and so imbued with the public interest that it would be possible and even desirable to entrust to them a great deal of the actual regulation and enforcement within their own field, leaving the government free to perform a supervisory or residual role ... At the present time, however, I have doubts as to the desirability, from the standpoint of the public interest, of assigning to exchanges such a vital role in the nation's economic affairs, before they adopt programs of action designed to justify their existence solely upon their value as public market-places. I have always regarded the exchanges as the scales upon which that great national resource, invested capital, is weighed and evalued. Scales of such importance must be tamper-proof with no concealed springs - and there must be no laying on of hands ... Such an important instrument in our economic welfare ... must be surrounded by adequate safeguards. Yet it is also obvious that such restrictions must be consistent with the profit motive, which in final analysis is and must remain the driving force in our economy".

A White Paper in the United Kingdom on financial services[38] summarised the main advantages of a system of self-regulation as follows:

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37 W O Douglas cited in Loss, above n 3, at 685.

38 Cmnd 9432 cited Tan Boon Teik, above n 5.

"(a) It offers the best possibility of combining investor protection with a competitive and innovative market;

(b) Regulation is likely to be more effective if there is significant practitioner involvement not only in devising the rules and enforcing them but also in encouraging the observance of high standards of conduct;

(c) A private sector body able to make and enforce rules would have greater flexibility in its operations than a body unable to change its rules other than by Parliamentary legislation;

(d) Practitioners are best equipped to spot breaches of the rules and to take swift and effective enforcement action; and

(e) Day-to-day regulatory action is distanced from the Government"[39].

There are, however, certain disadvantages which include:

"(a) Self-regulatory agencies whether Stock Exchanges or associations of dealers etc, since there is a natural reluctance to be regulated and a tendency to be influenced by self-interest, might not be as zealous as they ought to be in the discharge of their regulatory duties, for example, they may have different perceptions as to what is in the public interest. They may close their eyes to the need for organisational change or interpret their rules too liberally or be over-lenient in disciplining members etc. There is, of course, always the possibility of their being over-zealous in these and other areas to impress the Government supervisors that they are doing a good regulatory job; and

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39 *Ibid*, 194.

(b) Self-regulatory agencies would also have a tendency to carry on business in an anti-competitive or monopolistic manner. This would be contrary to the public interest for the main purpose of governmental policy is to ensure that markets operate fairly and efficiently. If this happens investors will not have confidence that their returns will be related to risks, that their institutions through which they deal have financial integrity and that the individual investor is not at a serious disadvantage compared with an institutional investor. Competition, it is said, will best contribute to these results. However, with diligent and expert supervision carried out by the relevant supervising authority, the chances are that these disadvantages will be greatly diminished"[40].

In 1990, long before the scandal of Barings Bank broke upon the scene, the Attorney-General for Singapore observed that pure systems of self-regulation were no longer acceptable. What was needed was "a two-tier structure of statutory and self-control" which would provide "flexibility in the control of the markets but also enhance investor protection, competition and innovation". Wisely he called attention to the growing internationalisation of securities transactions which has brought with it a number of additional legal and regulatory problems, especially where the transactions in question are executed across borders by electronic data transmission systems[41]:

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40 *Loc cit*.

41 *Id*, 197.

> "On the private international law side I will give one example only of what I am thinking of. Singapore through its SESDAQ has entered into arrangements with the USNASDAQ (both computer assisted markets) enabling Singapore investors to have access through terminals in the US market and vice-versa. USNASDAQ, I understand, is setting up similar arrangements with London. Are these transactions to be governed by Singapore or US law or, in the UK situation, by English or US law? The difficulties are compounded if the connection is between a common law country and a civil law country"[42].

The lesson of this comment is that problems in the area of regulation of the securities industry, far from becoming simpler are becoming more complex. Effective enforcement of security industry regulation, particularly where transborder data flows are involved, may be next to impossible unless there is relevant international law and effective international cooperation between institutions. For big criminality, a determined jurisdiction, such as Singapore, can secure extradition of the offender, mount a speedy trial and enforce its laws. But for minor infractions, or for proof of relevant relationships, knowledge and misuse of office, the difficulties of the past are compounded. Any modern consideration of securities industry regulation in general, and insider trading in particular, must take these factors into account.

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42 *Loc cit.*

CONCLUSIONS

I have now done what I set out to do. The suggested defects of the "unenforced and ineffective" New Zealand response to insider trading may be found in the Discussion Paper of the New Zealand Securities Commission, in academic commentaries and by a reading of such decisions as *Colonial Mutual Life Assurance Society Limited v Wilson Neill Limited*[43], *Kincaide v Capital Markets Equities Limited*[44] and *Re Bank of New Zealand; Kincaide v Capital Markets Equities Limited & Ors [No 2]*[45]. The alleged defects and inadequacies emerge clearly enough. If insider trading is prohibited, there would seem to be a strong argument that the provision of sanctions to uphold this parliamentary value-judgment should be more effective than those which ss 17 and 18 of the present Act afford. But what should the sanctions be? I have proposed:

(a) That the first task is a much more wholehearted endeavour to understand precisely what it is that we regard as an unacceptable interference in the operation of the securities

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43 [1993] 2 NZLR 617 (HC); [1994] 2 NZLR 152 (CA).

44 [1994] 2 NZLR 738 (HC).

45 (1995) 7 NZCLC 260, 718 (HC).

market and why. In short there must be more empirical and like research about what it is that we are concerned with and how widespread is the problem;

(b) That we must then define with greater exactness the reasons why insider trading should be prohibited so that, by doing so, we identify with proper modesty and restraint the ambit of the prohibition and the people and activities who fall within it; and

(c) That we must then attack in a more scientific way than we have in the past hitherto the design of the sanctions and remedies that uphold the given definitions and assessments so that a flexible and effective response is provided rather than a law, like those of Hamlet's Denmark, more honoured in the breach than in the observance. There are many legislative models, including reversal of the onus of proof, introduction of presumptions of insider profit within a given time of a take-over and detailed analysis of corporate activity to establish an insider's profit. Education in corporate ethics and explanations of their purpose may also have a part to lay. Lawmakers are not limited to simple choices such as civil v criminal or self v public regulation. Effective lawmaking is more complex than these simplicities.

The precise solutions are not easy to see. Indeed the definitions and dimensions of the problem are still obscure. No country has been wholly effective in legislative regulation in this area. But the beginning of wisdom is to ask the right questions.