AN ECONOMIC PERSPECTIVE OF INSIDER TRADING REGULATION AND ENFORCEMENT IN NEW ZEALAND

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Insider trading[1] of one form or another has most certainly been a part of society as long as markets have existed. As one peruses the world press it is clear that the appetite for prosecuting insider trading is worldwide. In the Pacific Basin, New Zealand and Japan have each just embraced their first national proscriptions of insider trading. Neighbouring Australia is currently caught in a debate how its untested insider trading provisions can be further strengthened. The anomaly throughout these developments is the lack of agreement among the bar, members of parliament, courts and even regulators over who or what is harmed by insider trading. Indeed, even a few experienced securities lawyers opine that insider trading is a victimless offence.

The following provides a close analysis of contemporary justifications frequently advanced for the regulation of insider trading. So as not to leave the reader with only a criticism, the author provides a coherent rationalization for the prosecution of insider trading. This rationalization is then contrasted with the objectives and provisions of New Zealand's recently enacted Securities Amendment Act of 1988 which provides private remedies against insider trading violations.

I IS INSIDER TRADING A VICTIMLESS CRIME?

1. *The Unfairness Argument*

The most elusive complaint lodged against insider trading is that it is "unfair". This complaint has two distinct aspects. First, the insider is seen as having an unerodible advantage over others who cannot obtain the same information. Second, the information was produced not for the benefit of the inside trader, but rather as a result of his employer's quest for gain.[2] As will be seen, the second point is an indispensable qualification of the first in characterizing insider trading as unfair, because the experience, intelligence, resources, or position of some investors will always give them superior insight into prospective market developments. No one believes it is unfair for an investor to purchase a security without disclosing his belief that the stock is a "bargain". On the other hand, disclosure of such information would be dysfunctional because it would deprive market professionals of the incentive necessary for them to continue their arbitrage of stock prices

[1] For the purpose of brevity, the expression "insider trading" when used in this article includes also wrongful tipping as well as trading on such a tip. All such practices are strictly proscribed under the laws of both America and New Zealand.

[2] See Brudney, "Insiders, Outsiders, and Informational Advantages Under the Federal Securities Laws" 93 Harv. L. Rev. 322, 356–357 (1979).

in light of publicly available information.[3] Similarly, the gains employers derive from this socially desirable behaviour is eroded, and hence such incentive behaviour stifled, if employees can make a pre-emptive use of such information.[4] An illustration closer to the shores of New Zealand is the ability of a bidder to secretly acquire up to three percent of a target corporation's stock without first disclosing its intent to make an above market bid. In short, the concept of "unfairness" represents nothing more than a highly stylized line separating lawful and unlawful conduct. The concern here is not simply to protect the benefits garnered by the production of information, but to protect as well the economic gains arising from that information's use by its producer.[5] Thus, most assertions that insider trading is unfair are coupled with additional harms believed to accompany insider trading.[6]

2. *Harm to Investors*

It is frequently asserted that insider trading harms investors. It is very difficult in most cases to identify who is injured by the trading in, or tipping of, material nonpublic information. To wit, an investor's decision to sell or to purchase is unaffected by whether the insider is also secretly buying or selling in the open market. If the insider neither trades nor discloses his confidential material information, one can nevertheless expect the investor to pursue his trading plan. To be sure, sellers are naturally disadvantaged by the nondisclosure of good news, just as buyers are disadvantaged by the nondisclosure of bad news. These results, however, cast no light on why the insider's decision to trade should prompt disclosure. Nor does it identify why or how the insider's trading, disassociated from his failure to disclose, harms his opposite trader. Viewed in such a limited fashion, the insider's trading is a mere fortuity as to his contemporaneous opposite traders.[7]

Modest support for the disclosure or abstain rule can be found if the trading and nondisclosure aspects of insider trading are disaggregated. Certainly the insider's trading does impact the supply and demand for the security traded in, so that the insider may pre-empt a price that was a lower "buy" price or a higher "sale" price than what would have been available to the investor if the insider had abstained from trading.[8] Under such a rationalization, the investor's injury is both problematic and trivial. It is purely in the realm of speculation what price would have been available to outside

[3] See Hethrington, "Insider Trading and the Logic of the Law" 1967 Wis. L. Rev. 720, 725–730.

[4] See Barry, "The Economics of Outside Information and Rule 10b-5" 129 U.Pa. L. Rev. 1307, 1323-1328 (1981).

[5] See Fleischer, Mundheim & Murphy, "An Initial Inquiry into the Responsibility to Disclose Market Information" 121 U.Pa. L. Rev. 798, 808--809 (1973).

[6] For example, Professor Brudney coupled his argument of unfairness with concerns for market efficiency, market integrity, manipulative practices, and the cost of capital. Brudney, supra at 334–335, 356.

[7] The fortuity is clear from analysis of the casual attitude American courts demonstrate when imposing rigid guidelines defining the class of investors permitted to share in the recovery of insider trading profits. See e.g. *Elkind v. Liggett & Myers Inc.* 635 F. 2d 156, 172 (2nd Cir. 1980) and *Fridrich v. Bradford* 542 F. 2d 307, 321 (6th Cir. 1976), cert. denied, 429 U.S. 1053 (1977).

[8] Wang, "Trading on Material Nonpublic Information on Impersonal Stock Markets: Who is Harmed and Who Can Sue Whom Under SEC Rule 10b-5?" 54 S.Cal. L. Rev. 1217, 1235-1350 (1981).

investors but for the insider's trading. Moreover, in a goodly number of cases, the resolution of this sticky factual question would appear hardly worthy of the considerable effort its resolution would entail. It would appear that in the vast majority of the cases, the insider's trading will have minimal impact on a stock's price. Moreover, there should also be considered the potential benefits of such insider trading may have conferred on parallel traders, those who also purchased when the insider purchased; for this group, the price and volume changes stimulated by the insider's trading may have attracted others to similarly trade so that such parallel traders unwittingly invested "in a sure thing". But the ultimate problem with the argument that the misdeed of insider trading is that the insider preempts a price otherwise available to others is that this assertion begs the question. Insiders are permitted to trade and thereby preempt a price available to outsiders when they are not in possession of inside information; therefore, why should they not similarly be free to trade and preempt a price when they are in possession of inside information?

3. *Manipulation Accompanies Insider Trading*

Insider trading regulation has frequently been justified on the basis that its proscription is necessary to protect securities markets from manipulative practices that would accompany a policy of *laissez faire* toward insider trading.[9] Tardy corporate disclosures would be the most likely form of manipulation. Delay gives insiders and others time needed to capture a greater share of the changes in the firm's value. Ambiguous corporate disclosures and signals can also be employed to create market uncertainty against which insiders with a clearer view can further their secret trading agenda. And insiders may even alter the timing of corporate activities for the sole purpose of creating intertemporal swings in the firm's value. In all cases, insiders can thereby reap the gains from their privileged knowledge of the direction of stock price movements.

Those who believe such abusive practices are far fetched should consider the on-going private action by F.M.C. corporation against Mr. Ivan Boesky.[10] F.M.C.'s investment banker had secretly advised F.M.C. to increase by $10 the consideration to be offered in its restructuring. On the basis of their secret knowledge of this dispute, Messrs. Boesky and Levine allegedly undertook massive purchases of F.M.C. stock for the purpose of causing F.M.C.'s management to approve the higher price. So massive was their purchases that they accounted for more than fifty percent of the trading volume during a one month period. The trading drove F.M.C. stock to a level that did in fact cause F.M.C. to increase the cash amount to be offered, thereby raising the total consideration by $220 million and producing a $20 million gain to Boesky.

To be sure, it is a rare inside trading case where such abusive practices

[9] Over fifty years ago, the United States' Congress proscribed so-called short-swing profits under section 16(b) of the Securities Exchange Act of 1934 out of a concern that if disincentives to insider trading were not provided by the removal of profits certain corporate insiders obtained by purchasing and selling their firm's securities within a six month period that the quest for insider trading profits would lead to abusive and manipulative collateral practices by such insiders. U.S. S. Rep. No. 792, 73d Cong. 2d Sess. 9.

[10] F.M.C. *Corp. v. Boesky* [1987 Transfer Binder] Fed. Sec. L. Rep. (C.C.H.) 93,233 (N.D. Ill. 1987).

have been found to exist and serve the insider's trading agenda. This does not imply, however, that such abuses do not more frequently accompany insider trading. Great uncertainty exists whether sound managerial judgment guided the timing of a corporate announcement and its ambiguities, the initiation or delay of a transaction, or the selection of a riskier project. Moreover, when such abuses are found, it appears far better to justify prosecution for the manipulation that occurred, rather than solely the incentive that drives that manipulative conduct. To justify insider trading regulation because of the difficulty in proving the presence of manipulative conduct believed to accompany insider trading is to perceive insider trading regulation as a necessary prophylaxis. For such a justification, a richer record of such abuse would appear to be required than currently exists.

Finally, close observers of insider trading prosecutions in America will report that most cases are against individuals who technically are not insiders. Most actions are against individuals who have no control over such intracorporate decisions, as the timing or content of corporate disclosures, let alone any control over corporate operations. In this respect, the manipulations engaged in by such glamour defendants as Messrs. Boesky and Levine are a rarity and hence a prophylaxis is all the more questionable.

4. *The Allocational Efficiency Argument*

The broadest justification some have advanced for insider trading regulation is the belief such regulation preserves investor confidences in securities markets and thereby enhances the allocational efficiency of securities markets.[11] While there is a good deal of public concern about insider trading, evidence that markets are adversely impacted by fears of insider trading, as distinct from other prevalent market practices, is not available. Instead of leaving to one's prejudices the question whether the magnitude of the malaise over insider trading is sufficient to implicate the allocational efficiency of markets, the case for regulation can be disposed of by assuming that investor concerns over insider trading are material. Even in light of this assumption, there is reason to doubt that the legalization of insider trading will interdict the allocational efficiency of securities markets.

Capital market theory offers a useful tool by which to examine this question. Insider trading occurs randomly because inside traders generally are not repeat players in the same corporation's stock on the basis of a separate corporate event. All firms do not experience the kinds of financial developments that offer extraordinary returns to insiders who trade before disclosure occurs. Outside investors, however, do not know *ex ante* which firms' managers possess inside information or for that matter will trade and/or engage in manipulative practices when in possession of such information. Due to these informational asymmetries, the rational investor will assume *ex ante* that

[11] See e.g., "that secondary securities markets affect the allocation of resources among competing productive uses is now well established". See Fama and Laffer, "Information and Capital Markets" 44 J. Bus. 289 (1971) and Hirschleifer, "The Private and Social Value of Information and the Reward to Incentive Activity" 61 Am. Econ. Rev. 561 (1971). This connection has thus stimulated most commentators to justify insider trading regulation in the belief it promotes, or at least protects, allocational efficiency. See e.g. "Schotland, Unsafe at any Price: A reply to Manne, *Insider Trading and the Stock Market.*" 53 Va. L. Rev. 1425, 1448–1449 (1967); Mendelson, "The Economics of Insider Trading Reconsidered" 117 U. Pa. L. Rev. 470, 477–478 (1969).

each firm poses the same risk of abusive insider-trading practices as does the market as a whole and will accordingly discount the value of each firm by the average estimated agency cost of all firms. In this way, the abuses associated with insider trading while occurring randomly with any specific firm become systematic across all firms due to the informational asymmetries that exist *ex ante*.[12] Because the risk is systematic, the risk cannot be reduced by diversification. Adding more stocks to one's portfolio only assures that the investor's exposure approaches that of the market as a whole.

So viewed, it can be seen that insider trading does not harm the individual investor. Each rational investor can self-insure against abusive insider-trading practices by discounting all stocks by the average risk for all firms. Investors armed with an efficient portfolio will have insider trading losses on one investment offset by higher returns garnered from portfolio stocks of firms not accompanied by insider trading. Over time, an investor can expect that his portfolio's insider trading losses will sum to zero.

As seen from the above analysis, rational investors whose collective judgment drive stock prices to their equilibrium levels will discount all stocks *ex ante* by the perceived agency cost of the market as a whole. So viewed, it is difficult to understand how insider trading interdicts the market's allocational efficiency. Because capital allocation occurs within the context of a comparative assessment among competing choices, any change that affects the cost of capital for all firms at the same rate will not affect the relative comparisons made by investors which comparisons drive the allocational efficiency of markets. Therefore, investors will not discriminate between firms that produce computers and those that manufacture automobiles solely on the basis of either set's potential insider trading abuses.[13] Investors will view each set of firms and each firm within a set as posing the same risk of insider trading abuses. Hence, legalization of insider trading under this "lock-step" paradigm would not adversely affect the allocational efficiency on an interfirm basis. The analysis is not affected by consideration of investment opportunities that occur in markets other than securities markets. That is, it may be argued that investors fearing insider trading abuses in equity securities may choose to invest in bonds or even real estate partnerships. If insider trading were isolated only to equity securities markets, then allocational efficiency would be affected by its presence in such investments but not other types of investment vehicles, such as bonds or interests in partnerships. But it can hardly be expected that investors considering equity securities versus

[12] See generally, Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanisms" 84 Q.J.Econ. 488 (1970).

[13] To be sure, it may arise that individual firms may seek to reduce their cost of capital by engaging in nontrivial bonding, monitoring and signaling costs designed both to deter insiders from harmful insider trading practices and to signal effectively that their firm poses a lower risk of such practices. Ross, "Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signaling Theory" in *Issues in Financial Regulation* 117 (F. Edwards ed. 1979). See also, Dooley, "Enforcement of Insider Trading Restrictions" 66 Va. L. Rev. 1, 46–47 (1980). However, any such undertaking by the individual firm will balance the marginal cost of each additional unit of bonding, monitoring and signaling against the accompanying marginal benefits of reducing its managers' trading. Jensen & Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" 3 J. Fin. Econ. 305, 328–329 (1976). Therefore, no firm will ever be completely free from investor discounting because some level of abusive insider trading practices will remain optimal because it is not economical to stop such practices at all costs.

alternative investment mediums will consider any investment that requires their active participation in management. They will instead be seeking passive investment devices. All such passive investment entails either a direct managerial component or an external component that is connected with a managerial component which assures informational asymmetries between the investor and those within the managerial component. This situation assures that insider trading type abuses will not be limited to equity markets. Indeed, there have even been insider trading cases in risk-free treasury bills; insiders have secretly traded in treasury bills on private knowledge concerning changes in the terms of new government offerings.[14]

5. *Protection of Another's Information*

The most evident impact of insider trading is upon the property rights of the person for whose benefit or enterprise the information upon which the insider trades was created. The most fully reasoned opinion focusing on this dimension of insider trading's harm is that of the United Supreme Court in *Carpenter v. United States*.[15] In *Carpenter*, Winans' and his accomplices' convictions for mail fraud were upheld upon proof that they had misappropriated their advance knowledge of the content of the Wall Street Journal's "Heard on the Street" column, which Winans coauthored for its publisher, Dow Jones and Company.

The Court emphasized the publisher's interest in the confidentiality of the contents and timing of the column's contents, recognizing this information as a protectable property right.[16]

> Confidential information acquired or compiled by a corporation in the course and conduct of its business is a species of property to which the corporation has the exclusive right and benefit, and which a court of equity will protect through the injunctive process or other appropriate remedy.

The Court said the injury occurs by the misappropriation of this information, without proof of competitive injury to the publisher. It was "sufficient that the Journal has been deprived of its right to the exclusive use of the information".[17] Upon finding that the employer had been deprived of its property by a fraudulent scheme, the Court upheld the conviction for mail fraud.

If instances of tangible harm from misappropriating another's information are needed to convince the skeptical of the wisdom of a general proscription of insider trading, it can be found in cases such as the F.M.C. Corporation, discussed earlier, in which Boesky's unauthorized use of confidential knowledge caused F.M.C. to incur $220 million in additional payments incident to its restructuring. Also consider the case involving Paul Thayer, who while a director of Anheuser-Busch Corporation, revealed its plan to make a tender offer for Cambell-Taggert Inc. As a consequence of Thayer's tip, a significant increase occurred in the market price of Cambell-Taggert stock before Anheuser-Busch announced its offer. To assure that its tender offer price would be attractive, Anheuser-Busch raised its offering price. It was thereby

[14] See e.g. *In re* Blyth & Co. 43 S.E.C. 1037 (1969).
[15] [1987 Transfer Binder] Fed. Sec. L.Rep. (C.C.H.) 93, 423 (U.S. Sup. Ct. 1987).
[16] Ibid. at 97, 197–4.
[17] Ibid. at 97, 197–4–5.

forced, because of illegal tipping and insider trading, to pay about $80 million more than first estimated for Cambell-Taggert.

To be sure, not all instances of insider trading will pose tangible harms such as those illustrated in the cases of F.M.C. and Anheuser-Busch. But the purpose of regulation should not be to proscribe that for which only tangible harm is possible.[18] Much like the crime of attempt, there are societable benefits of protecting the property interest from the threat of injury, whether or not injury results. In the case of inside information, the interest protected is the incentive behaviour that underpins the information's production. Regulation should thus function prophylactically. If insider trading were proscribed only when there is a distinct tangible harm to the owner of the information, curious incentives would thereby be created to trade in the hopes that no accompanying harm can be identified; such incentives are not offset by any socially useful behaviour on the insider's part for having so stimulated his misappropriation of, and trading on, another's information. Moreover, the enterprise for whose special benefit the information was created will incur higher transaction costs to assure the information's confidentiality. The latter will occur because any additional element to making out the offence, in this case proof of harm, necessarily interjects an uncertainty into whether the insider will be sufficiently admonished for his offence. As between the insider and the enterprise, the latter can be expected to be the more risk averse; indeed there is reason to believe the former is risk preferring.[19] Hence, the effect of making a successful prosecution more difficult is that it will actually increase the frequency of violations. In sum, actual proof of harm would be dysfunctional.

II The Economics of Public Protection of Private Property

The foregoing review leads to a seemingly precarious foundation for insider trading regulation. The central concern developed above is that insider trading regulation cannot be justified in the interest of protecting investors or securities markets, but rather the property interest in the information's confidentiality.[20] An even more profound jurisprudential issue arises when one considers the possibility that insider trading can be criminally sanctioned. And there is

[18] American case law upholds the right of a corporation to proceed against its employees who breach their fiduciary duties by trading in securities on the basis of their employer's confidential information. However, the cases do not agree whether the employer's recovery can only occur if it suffers a tangible loss as a result of the employee's breach. Compare *Diamond v. Oreamuno* 24 N.Y. 2d 494, 248 N.E. 2d 910, 301 N.Y.S. 2d 78 (1969) (a reputational injury can be presumed) with *Schein v. Chasen* 319 So. 2d 739 (Fla. 1975) (recovery only upon proof of injury).

[19] See generally, Becker, "Crime and Punishment: An Economic Approach" 76 J. Pol. Econ. 169 (1968).

[20] This feature of insider trading regulation is illustrated by American developments under which the proscription based on the notion that the insider stands in a fiduciary relationship to those in the market and hence owes a disclosure duty before trading, *Chiarella v. United States* 445 U.S. 222 (1980), was immediately perceived as not providing a sufficiently encompassing disclosure duty, so that the prevalent theory today is that of misappropriation of another's information. See e.g. *United States v. Newman* 664 F. 2d 12 (2nd Cir. 1981). Under the misappropriation theory the "unfairness" to employment relationship that occurs by unauthorized use of the employer's information is emphasized and not deception of investors. See e.g. *S.E.C. v. Materia* 745 F. 2d 197, 201-202 (2nd Cir. 1984).

the anomaly that even though contemporaneous traders, under the above analysis, appear not to have incurred any harm by the fortuity of the insider's trading, they nevertheless enjoy a private right of action against the insider trader. Each of these anomalies are present not only in New Zealand, but also in America whose rich experience in dealing with insider trading provides some insights into how such anomalies are rational mechanisms for the protection of another's property interest.

1. *Centralized Enforcement*

Private litigation has not been a necessary or even an effective weapon in the detection or deterrence of insider trading in America. To be sure, in other areas of the American federal securities laws, the class action and contingency fee arrangement are important and indispensable devices for assuring compliance with disclosure requirements. In the case of insider trading, however, nearly all cases initiated are by the government.[21] Occasionally the publicity surrounding such government prosecutions stimulate collateral private actions; these suits are parasitic in nature in that they free ride on the government's evidence and frequently seek to share in any profits the government cases causes the defendant to disgorge. Moreover, the government has won a series of decisions upholding the power of the courts to order broad ancillary relief incidental to the government's prosecutions; the effect is that government proceedings frequently result in a mechanism for substantial awards occurring to private parties.[22]

In an earlier time, the criminal courts of England were a joint enterprise between the victim and the government. The victim served as prosecutor and shared with the state any fine resulting from a successful prosecution.[23] Today in America much the same occurs in the prosecution of insider trading: whether the government prosecution is criminal or civil, the remedy frequently includes restitution to those believed injured by the insider's conduct. In light of the natural efficiencies concomitant with the detection of insider trading, the centralized prosecution is also an efficient response.

That enforcement of insider trading is so centralized is a natural effect of the offence. Insider trading is an offence of stealth whose presence initially can only be detected inferentially. That is, the explanation for public prosecutions of insider trading are partly technological and partly the natural efficiencies of the enforcement effort. The government's enforcement efforts are heavily dependent upon electronic market surveillance systems maintained by various American self-regulatory[24] organizations. The same process will surely evolve within New Zealand so that a brief review of the American system is instructive.

The organizations first monitor trading activity through sophisticated computers that can identify abnormal price or volume changes within seconds of their occurrence. Once such trading abnormality is detected, a review of wire releases occurs to determine whether the trading activity can be explained

[21] Dooley, supra.

[22] See Ellsworth, "Disgorgement in Securities Fraud Actions Brought by the S.E.C." 1977 Duke L.J. 641, and Farrand, "Ancillary Remedies in S.E.C. Civil Enforcement Suits" 89 Harv. L. Rev. 1779 (1976).

[23] Pollock & Maitland, *History of English Law* vol 2 449–462 (2nd ed. 1898).

[24] The involved organizations are the seven national and regional exchanges as well as the National Association of Securities Dealers.

by market, industry or company specific information. If nothing appears from a perusal of the various wire services available to the organizations, the subject company is contacted to determine if there is a corporate event not yet announced. The organizations also perform a retrospective review of trading in listed company's stock for possible abuses before an important release of corporate information. Once suspect trading is identified, the self-regulatory organization's investigators move into the second stage. The brokerage firm executing the suspect transactions are identified and through them a profile of the trading customers is prepared. This information is screened through the Automated Search and Match System (A.S.A.M.) to determine the trader's relationship, if any, with the listed company. A.S.A.M.'s data base includes the names and general information for over 500,000 corporate officers, directors, attorneys, accountants, and other individuals having corporate contacts. The screening can also look for characteristics common to both a suspect trader and another person who appear within the A.S.A.M. data base. For example, the investigator's suspicions are increased when the trader's *alma mater* or club affiliation match those of the issuer's executive. And, of course, investigators use simple old fashion investigative questioning to determine if trading on the basis of inside information has occurred. When the investigators believe insider trading has occurred, they forward their evidence to the government prosecutors.

From the above description it can be seen that centralized enforcement of insider trading enjoys something akin to a natural monopoly. Because its presence can in most instances only be observed initially from a close inspection of abnormal trading and because such inspection requires an elaborate investment in computers and manpower, it is not reasonable to expect detection to occur other than by some centralized means. Not all insider trading cases, however, have come to the government's attention through the use of sophisticated computer surveillance.

The reliability of contemporary computer surveillance techniques is seriously questioned by a review of the massive insider trading activity of Mr. Dennis Levine. In 1985, the New York Stock Exchange surveillance staff directed to the Securities Exchange Commission eleven different reports of questionable trading practices occurring through the Bank Leu; however, this suspicious trading pattern did not lead to a prosecution by the S.E.C. because there was insufficient collaborative information. Later, Merrill Lynch Pierce Fenner and Smith, a brokerage house, after receiving an anonymous tip, presented evidence to the S.E.C. which connected Dennis Levine with the Bank Leu.[25] The investigation of Mr. Levine's trading revealed a pattern of insider trading abuses going back to at least 1980. In light of the Levine experience, it is not surprising that the United States Congress has recently augmented available detection procedures by providing a bounty award of up to 10% of the government recovery for those who assist the government's detection of insider trading.[26]

[25] See Hearings on "Insider Trading before the Subcommittee on Telecommunications, Consumer Protection, and Finance of the Committee of Energy and Commerce" House of Representatives, 99th Cong. 2d Sess. July 23, 1986.

[26] Insider Trading and Securities Fraud Enforcement Act 1988, amended section 21 A(e) Securities Exchange Act, 15 U.S.C. 78 to provide for this award.

2. *Sanctions and Control Person Duties*

Enforcement mechanisms are not the only factor relevant to deterring insider trading. The nature and extent of the penalties imposed are also important. The S.E.C. has since 1984 had authority under the Insider Trading Sanctions Act to seek civil penalties up to treble the insider trading profits against persons who commit insider trading violations.[27] This provision was recently amended[28] to apply this sanction to brokerage houses, investment advisory firms, and other organizations who failed to take appropriate steps to prevent insider trading violations by their employees. Specifically, the civil sanction applies where the employing organization has failed to take appropriate action once aware or in reckless disregard of circumstances indicating a likelihood that an employee was engaging in an ongoing insider trading violation or was about to engage in such a violation.[29] The employer can also be sanctioned if it "knowingly or recklessly failed to establish, maintain or enforce" the policy and procedures "reasonably designed to prevent the misuse of material, nonpublic information" and "such failure substantially contributed to or permitted the occurrence of" insider trading.[30] The expanded liability of employers operates in tandem with amendments to the Securities Exchange Act[31] and Investment Advisers Act[32] which impose upon broker-dealers and advisers an affirmative duty to institute, maintain and enforce a reasonable and proper system of supervision, surveillance and internal control to protect against insider trading violations by their employees.

By expanding civil sanctions to employers, the United States Congress recognized that civil sanctions will increase the economic incentives for employers to supervise vigorously their employees. Such private actions are seen as a desirable concomitant to public enforcement efforts. In this respect, centralized insider trading regulation has been augmented by the dispersed efforts of others. While this can be seen as evidence of Congress' waning patience with the frequency of insider trading, particularly among market professionals, it can also be reasoned that the marginal returns of further centralized efforts are not nearly as great as enhanced efforts by employers who enjoy a special position to curb the errant acts of their employees.

III The Efficiencies And Pitfalls of The New Zealand Scheme of Regulation

New Zealand's proscription of insider trading, tipping and tippee trading bear a strong resemblance to America's definition of these concepts. The American experience can, therefore, serve as useful reference point for possible tensions to be encountered in New Zealand's regulation of these abuses. The Securities Amendments Act of 1988 offers a definition of insider[33] as broad

[27] S.21(d)(2)(A) Securities Exchange Act 15 U.S.C. 78 (qq) (1984).

[28] Insider Trading and Securities Fraud Enforcement Act 1988.
[Hereinafter reference to changes introduced by this act are to their designation within the Securities Exchange Act or Investment Advisers Act].

[29] S.21A(b)(1)(A).

[30] Securities Exchange Act s.21A(b)(1)(B).

[31] Securities Exchange Act s.15(f).

[32] Investment Advisers Act s.204A.

[33] S.4 Securities Amendments Act [hereinafter Securities Act] defines insider to include not only the public issuer, but its principal officer, employees and substantial stockholder as well as one to whom information is by such a person "in confidence".

as that now embraced in America. Moreover, inside information[34] is much like the American standard: not only must the information be nonpublic but also of a quality that "would be considered important by the reasonable investor."[35] While New Zealand imposes a test of whether the information would likely affect the security's price upon its disclosure,[36] this is a difference without significance. Insider trading cases arise when insiders have in fact traded on their advance knowledge of information that *actually* did cause a material change in the securities price. The regulation of wrongful tippee trading in New Zealand is also very similar to that in America. However, there is a distinct discontinuity between New Zealand's proscription of wrongful tipping and conduct that constitutes wrongful tippee trading. The Act reaches tippee trading by deeming outsiders who receive information in confidence from an insider as themselves being insiders.[37] On the other hand, wrongful *tipping* does not depend upon whether the principal officer, secretary, employee or substantial stockholder of the public issuer disclosed the inside information "in confidence".[38] Liability arises if the tipper either encourages another to trade or communicates the inside information with knowledge or the belief his tippee will trade. It is the latter which is the most pernicious. Consider the rather standard practice of high company officials meeting with selected investment analysts to discuss the company's performance and prospects. Frequently information revealed in such discussions is not always public information. This is best illustrated by the facts in *S.E.C. v. Bausch & Lomb, Inc.*,[39] in which Bausch & Lomb and its chief executive officer, Shulman, were prosecuted for negligently revealing to groups of analysts the negative impact that problems with Bausch & Lomb's "Softlens" product would have on the company's performance. For weeks Bausch & Lomb was hounded by analysts for a definitive statement of the effect recalls and returns of Softlens would have on the firm. Due to fatigue and simple inadvertence, Shulman revealed the firm's internal predictions. This revelation caused a rash of trading by the analysts and, more significantly, their advisees. The S.E.C.'s prosecution was unsuccessful because the court held that mere negligent misconduct was not proscribed by the antifraud provision, Rule 10b-5, under which most American tipping and insider trading prosecutions occur.

Today, the bulwark protecting American corporate executives in factual situations such as *Bausch & Lomb* is provided by the U.S. Supreme Court's holding in *Dirks v. S.E.C.*,[40] where Secrist, a former officer of Equity Funding of America, informed Dirks, an investment analyst, that Equity Funding's assets were fraudulently overstated. In the course of aggressively investigating Secrist's tip, Dirks shared Secrist's revelation with 5 investment advisers who caused their advisees to liquidate more than sixteen million dollars worth of Equity Funding stock before the scandal was publicly disclosed. The

[34] S.3 Securities Act.

[35] See e.g. *S.E.C. v. Texas Gulf Sulphur* 401 F. 2d 833 (1968), cert. denied, 394 U.S. 976 (1969).

[36] S.2(e)(b) Securities Act.

[37] S.4(f) Securities Act rests upon whether the confidential information was received from the public issuer, its principal officer, secretary, employee, or substantial security holder.

[38] S.10 Securities Act.

[39] 420 F. Supp. 1226 (S.D.N.Y. 1976), aff'd, 565 F. 2d 8 (2d Cir. 1977).

[40] 463 U.S. 646 (1983).

Supreme Court held that illegal tipping and tippee trading occurs only when the selective disclosure is deemed to be "improper". The Supreme Court then offered an extremely narrow concept of what constitutes an "improper" tip: a disclosure is improper if the insider tips a relative, tips a friend, or expects to reap a pecuniary gain from the selective disclosure.[41] In reaching this conclusion, the court demonstrated a very pragmatic view: to have held otherwise in Dirks would have had a chilling effect on the socially desirable activities of security analysts. Thus, *Dirks'* brightline standard extends to analysts a license to pursue aggressively corporate insiders for nonpublic information without fear that their success will not expose them to charges of insider trading.

The New Zealand provision's requirement that the disclosure be made "in confidence" no doubt will protect the analyst in *Bausch & Lomb*, where the obvious intent is for the information to reach the market place; the result in *Dirks* is less clear. Secrist's revelations were made with the intention that Dirks would make Equity Fundings' fraudulent practices public knowledge. If so viewed, Dirks appears protected. But the warning to Secrist is to stay away from New Zealand's shores, for wrongful tipping is not conditioned, as is tippee trading, on the disclosure being for a confidential purpose. Under section 9 of the Securities Amendment Act it is unlawful if an insider communicates inside information knowing or believing the other person will or is likely to trade. Thus, the great problem of New Zealand's regulation is likely to be that it will not only reach individuals such as Secrist, but also executives such as Shulman in *Bausch & Lomb*. Such a result appears clearly inconsistent with otherwise acceptable methods for information to reach securities markets. In any case, the ambiguity that exists is clearly an undesirable one.

New Zealand's Securities Amendment Act is distinctive among legislative proscriptions of insider trading. It focuses its principal deterrent and compensatory efforts through the rights of the issuer of the shares traded by the insider and not upon government enforcement efforts. With its reasonably broad proscription of insider trading, the Securities Amendments Act accords the public issuer a right of action against the insider for the gain the insider garnered. Additionally, the issuer may also recover a fairly sizable penalty, up to the greater of the price of the securities traded or treble the insider trading profits.[42] In this respect, the Act appears persuaded by, or at least is consistent with, the preceding analysis that the most tangible interest threatened by insider trading is the public issuer's property interest in preserving the information's confidentiality.

To be sure, the Securities Amendment Act also accords contemporaneous traders who purchased from or sold to the insider a right to recover any gain they were deprived of, or any loss incurred, because of the insider's failure to disclose before trading.[43] Because this civil remedy will never exceed more than the profits the insider wrongfully obtained or the loss he has illegally avoided, the contemporaneous trader's remedy should be viewed as secondary to that of the public issuer. Mere disgorgement of gains garnered or losses avoided provides a very mild disincentive for insider trading; the

[41] Ibid. at 663-664.
[42] S.8(4) Securities Act.
[43] S.8(2)(a)(b) Securities Act.

insider is hardly worse off by failing to trade on his confidential information than if he trades and is reprimanded by having to disgorge what he would have lost had he not traded. Therefore, the real deterrence to insider trading in New Zealand, and elsewhere, is that an insider, if caught, will lose significantly more than his illicit gains. In this respect, we can detect the first parallel in reasoning between America's Insider Trading Sanctions Act, discussed above, and New Zealand's recent reform legislation.

New Zealand's enforcement mechanism also includes the efficiencies concomitant with the ancillary remedy available to American government prosecutions. Section 19 provides that any sums recovered through the public issuer's action may be applied by the court to contemporary traders or others.[44] As seen in the discussion of American procedures, this obviates the need for a wasteful secondary action. Further, it recognizes the primacy of the issuer's action against insiders and foresees that occasionally insider trading visits serious financial losses upon others.

The parallel between America and New Zealand, as well as the above argument that the U.S. government enjoys something akin to a natural monopoly, is disturbed by the decentralized nature of New Zealand's remedies against insider trading. As seen, the remedy exists in the first instance with the public issuer and is supplemented by the prospect of a private action by contemporaneous traders in privity with the insider. The public issuer can be indirectly stimulated to initiate an action to impose the pecuniary penalty against an insider, for a "person to whom this [section 17] applies" may, with the prior approval of the Securities Commission, cause the issuer to secure an opinion of a barrister or solicitor approved by the Commission whether the issuer has a cause of action for insider trading.[45]

Certainly, if the consulted attorney renders a positive reaction to the allegations, the public issuer will be hard pressed not to proceed with the action. Moreover, section 18 of the Act permits a court to grant standing to certain parties to prosecute the public issuer's cause of action against the insider.[46]

The procedures permitted by section 17 and 18 were actively considered by U.S. House of Representative when deliberating the recent insider trading legislation. The provisions were not included in the bill that became law; the bounty provision, discussed earlier, was viewed as a less disruptive and, hence, more acceptable alternative. It must be observed that the bounty provision preserves the role of the U.S. government as the principal enforcer of insider trading regulation in America; whereas conferring standing to initiate an action for insider trading upon any citizen would have been a radical, if not pernicious, departure from custom. Even though New Zealand and America have thus diverged on their particular resolution of this issue, the reasoning in support of each country's approach appears consistent with one another.

While there is much evidence that centralized enforcement with the aid of sophisticated computer surveillance devices is most efficient, there is a good deal of slippage within that system. As seen, the United States Congress

[44] S.20 Securities Act authorizes the court where appropriate to have the recovery paid or applied to a charitable purpose whenever it would be inequitable to permit the public issuer to retain the pecuniary penalty.

[45] S.18 Securities Act.

[46] S.19 Securities Act.

sought a relatively costless means of enhancing enforcement efforts by providing bounty awards from funds extracted from the defendant himself. By providing a mechanism for a member of the public issuer to not only initiate an action but also for his attorney to be compensated, the Securities Amendment Act provides an important incentive for private enforcement of the Act's proscriptions. Rewards for initiating such litigation in New Zealand under section 18 arise because the litigation fees of the movant are absorbed by the public issuer.

Such decentralized enforcement efforts in New Zealand may well be optimal in light that the New Zealand securities market activities do not now make investment in the equipment and manpower for aggressive market surveillance a cost effective alternative.[47] Before launching into an elaborate investment in market surveillance equipment and personnel, it may be wise to first assess the effectiveness of the decentralized method described above. Moreover, there is even reason to believe that issuer based actions are more likely to be initiated than actions brought by the insider's contemporaneous traders. The touchstone for this belief are the weak incentives that surround actions brought on behalf of such contemporaneous traders. First, the amount of such recoveries under the New Zealand provisions, as well as American law, cannot exceed the insider's illicit trading profits. Thus, if the private attorney is to be compensated by the plaintiff in such actions, it may well be that the costs of the proceeding will overwhelm the expected recovery. Second, no individual investor may have lost a sufficient amount to make such litigation worthwhile. This problem is exacerbated by the absence of class action suit devices. A third problem is that investors faced with uncertainty in initiating the suit's action and facing a small recovery will be most reluctant to incur ex ante substantial attorneys fees. This problem is overcome in America by the contingency fee device which permits the private bar to be less risk averse than their class of clients. On the other hand, far stronger economic rewards accompany the action brought on behalf of the public issuer. The attorney's efforts are handsomely subsidized and the remedy available to the issuer is not simply disgorgement of the insider's profits, but can be as great as three times those profits.

As discussed above, America has enacted strong measures to stimulate various market professional organizations, such as brokerage houses, to undertake significant efforts to deter and detect insider trading. The benefits of this process can be seen as recognizing that such employers may incur lower marginal costs either to deter or to detect insider trading than an additional enforcement effort from a centralized body. In any case, the legislation recognized that such employing organizations have an important role to play in the regulation of insider trading.

Although New Zealand does not impose liability on such control persons, it does provide a novel incentive for employers to deter insider trading. This occurs in two areas. The Securities Amendment Act at several points extends to organizations a defence to insider trading when there exists within that organization a reasonably designed structure that assures that the trading

[47] Consider that approximately 90 individuals are employed by the market surveillance staff of the New York Stock Exchange. The body's 1986 budget was $8 million of which $3 million was allocated to equipment acquisition for surveillance.

division did not possess inside information within the knowledge of some other employee of that organization.[48] This provision essentially embodies the well-established "Chinese Wall" defence to an organization's trading. A retrospective view of the American experience is that even the best designed Chinese wall is extremely porous. Hence, the recent imposition of control person responsibility upon broker-dealer and investment advisory organizations was undertaken to improve upon those organizations' experiences with Chinese walls.

A second area of self-regulatory focus is the curious provision that exempts an insider provided the Securities Commission has declared that issuer to be "an approved public issuer".[49] This determination requires a finding that the issuer has satisfactory procedures to assure that its insiders in possession of inside information do not deal in securities. The availability of this exemption reflects the draftsman's desire to facilitate company officers holding their firm's securities. An obvious Catch 22 surrounds this provision. There is little cause for an exemption if insiders armed with inside information do not trade; the section's protection is triggered only when one has traded on inside information under circumstances in which it is reasonable to conclude that procedures — adequate and therefore satisfactory in the abstract — failed in that specific instance. So viewed, the provision can be seen as an attempt to trade off the occasional slippage that may arise within efficiently designed Chinese walls for better walls on average. It is not economical to design a bulwark against insider trading at all costs; some misbehaviour is economically optimal. The New Zealand legislative scheme seeks, through raising enhanced internal protections within many qualifying firms, to reduce the overall incidence of insider trading by an amount sufficient to overcome the occasional slippage within the system. Thus, both America and New Zealand recognize the role of employing organizations in the enforcement of insider trading. However, on this issue New Zealand accomplishes its objectives with the carrot, whereas America, growing dissatisfied with the frequency of insider trading by market professionals, has proceeded with a club.

IV Impact of Sharemarket Inquiry

The most significant development in the regulation of insider trading, and New Zealand securities markets generally, are the sweeping recommendations in the Sharemarket Inquiry.[50] The report's overall theme is to recognize the potential regulatory strengths of self-regulatory organizations, such as the New Zealand Stock Exchange, whose authority transcends mere development of rules of conduct for brokers and dealers, but will have authority to discipline its members for any infractions. Importantly, the Sharemarket Inquiry recommends that all self-regulatory organizations would operate under the vigilant eye of a Supervisory Authority[51] whose authority and mission would

[48] S.11 Securities Act.

[49] S.9 Securities Act.

[50] Sharemarket Inquiry, "Report Of Ministerial Committee Of Inquiry Into the Sharemarket" (March 1989).

[51] See Inquiry at 6.4.1. The Sharemarket Inquiry does not specify whether the Supervisory Authority should be the present Securities Commission whose powers are expanded or whether the Commission should be collapsed into a new body with larger powers. Ibid. at 6.2.

be greater than that of the present Securities Commission.[52] The collaborative enforcement mission of the Supervisory Authority and self-regulatory organizations respond to the fact that it is not an effective use of public resources to establish a large governmental bureaucracy to police New Zealand's relatively small securities markets. Nonetheless, the Sharemarket Inquiry does empower the Supervisory Authority with not only enforcement powers, but also envisions the installation of an enforcement staff.[53] The Sharemarket Inquiry expressly envisions the dual enforcement of insider trading laws by the Supervisory Authority and the self-regulatory organizations.[54]

The Sharemarket Inquiry's proposals do not detract from the substantive and procedural weapons New Zealand now has to combat insider trading activities. The proposals offer a framework for nurturing an enforcement partnership between a governmental body and self-regulatory organizations. Within that partnership, it is possible that important substantive changes can overtime evolve. For example, the self-regulatory organization rules may well impose some affirmative duties on broker-dealer organizations to supervise their employees more closely to assure no insider trading abuses similar to those recently enacted into law in America. And, with the active involvement of self-regulatory organizations, there is a significant enhancement in both the detection and enforcement resources for a wide range of market abuses, including insider trading. It would therefore appear that New Zealand will be well served by the proposals put forth in the Sharemarket Inquiry. And overall, it is well served by the insider trading proscriptions of the Securities Amendment Act of 1988.

[52] See Inquiry at 6.1, 6.2.
[53] See Inquiry at 6.4.1.
[54] See Inquiry at 6.4.4.