MATERIALITY: AN OBSTACLE TO ENFORCEMENT OF INSIDER TRADING LAW

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Introduction

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

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

At the time of Manchee's sale, the market had already moved the share price to a level that reflected "the substantial likelihood" of a takeover. The further non-public information that Manchee held, that Citigroup was acting for the bidder, was not material. But the Court analysed the materiality of other information held by senior Citigroup officers: knowledge of the timing of the announcement of the takeover bid. The

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[1] Glenn F Miller, 'Comment, Staff Accounting Bulletin No. 99: Another Ill-Advised Foray into the Murky World of Qualitative Materiality' (2000) 361 *Northwestern University Law Review* 389 at 363.

[2] Yvonne Ching Ling Lee, 'The Elusive Concept of Materiality under U.S. Federal Securities Laws' (2004) 40 *Willamette Law Review* 661 at 664.

[3] Ibid.

[4] Miller, above n 1, at 368.

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

Court's materiality analysis of this information reflected a pure "market impact test". Before the start of trading on Monday, the takeover was announced to the market. The Court decided knowledge of the timing of the release was material because the Patrick shares opened the day of the announcement at $7.19, 10.9% higher than the closing price the Friday before.

The price movement between the close of trading on the Friday and the open of trading on Monday after the announcement could have been attributed to a number of factors. Perhaps the speculation in the market that existed on Friday had convinced investors over the weekend to buy shares at the open of trading on Monday. Or perhaps the 10.9% rise was in part the market's response to the announcement itself, not purely knowledge of the timing of the announcement. On Sunday, none of the insiders could have known the exact extent of the reaction of the market. Knowledge of the timing of the announcement is of little value to an inside trader without the accompanying knowledge of the likely direction and extent of the reaction of the market.

This article will look at the new definition of material information and investigate how the change in the underlying rationale for regulating insider trading might affect this element of insider trading. An attempt will be made to elucidate the threshold for materiality based on the decided cases in New Zealand, Australia, and the United States (US). It will also consider whether the adoption of the concept of materiality as the threshold test for defining 'inside' information is a barrier to enforcement rather than serving to facilitate the enforcement of insider trading prohibitions

A. The change from a fiduciary rationale to a market fairness rationale

The explanatory note to the Securities Legislation Bill 2006 ("the Bill") proposed that the Bill would strengthen the law relating to insider trading by adopting a regime that is based on upholding market integrity and confidence of the investing public as opposed to one based on a breach of a duty owed to the company.[6] The Securities

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

Markets Amendment Act 2006 "SMAA" removes the requirement that an insider is connected to the company.[7] An insider is defined solely by possession of inside information. In the absence of a connection to the company, the material and non public qualities assume increased significance.

Under the SMAA there are 5 elements to insider trading:

1. There needs to be some material information;[8]
2. The information must not be generally available;[9]
3. A person must have possession of the information;[10]
4. A person must know, or ought to reasonably know,[11] that the information is material and not generally available.

Once these elements have been satisfied the person is an "information insider" of the public issuer[12] who possesses "inside information"[13] and must not: trade in the shares of the issuer;[14] disclose the information to anyone where they might act on the information;[15] or advise or discourage trading in the shares of the issuer.[16]

Information is not defined under the SMAA. A definition is important because an assessment of materiality can ultimately depend on the substantive content of the information.[17] In Australia, information can be as broad as an "un-communicated supposition"[18] and need not be

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[7] Section 3 Securities Markets Act 1988 (SMA) defines an insider as:
a) the public issuer; or
b) a principle officer, employee or company secretary who has information by virtue of their position; or
c) a tippee who receives information in confidence from a principle officer, employee or company secretary; or
d) a tippee of the first tippee.
[8] SMAA section 8A(1)(a).
[9] SMAA section 8A(1)(a).
[10] SMAA section 8A(1.
[11] SMAA section 8A(1)(b)(c).
[12] SMAA section 8A.
[13] SMAA section 8B.
[14] SMAA section 8C.
[15] SMAA section 8D.
[16] SMAA section 8E.
[17] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373.
[18] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA 963, at paragraph 542.

specific.[19] Courts in New Zealand and Australia do not explicitly categorise different types of information like the US courts.[20] The different types of information (hard, soft, forward looking, and backward looking) complicate materiality assessments.

Reliability is one of the main factors an investor takes into account when deciding whether to act on information.[21] Hard information is information about the past or present. It can be verified by objective facts in the past or present, therefore it has a high degree of reliability.[22] Conversely, soft information is defined by the fact it cannot be verified by objective facts.[23] It may contain an element of opinion or judgement, or may be information about something unquantifiable.[24] Soft information contains a much lower degree of verifiability, and therefore reliability.

Although it may be less reliable, forward looking predictive information probably holds the most utility for investors.[25] For a person looking for a sound investment, predictions about the future profitability and opportunities for the company are more relevant than past performance[26] (therefore more likely to be material than backwards looking information). This reveals the second important feature of

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[19] Corporations Act 2001 section 1042A; *Ampolex Ltd v Perpetual Trustee Trading Co (Canberra) Ltd* (1996) 20 ACSR 649 at 658; *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373; Cf the UK approach, Alexander F Loke, 'From the Fiduciary Theory to Information Abuse: The Changing Fabric of Insider Trading Law in the U.K., Australia and Singapore' (2006) 54 *American Journal of Comparative Law* 123 at 147-148.

[20] *Basic Inc v Levinson* (1988) 485 US 224 at 984.

[21] *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 51- 52, paragraph 73 "if he (McGowan) had been the source it was relatively authoritative and would have been taken more seriously."

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

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

[24] Jude Sullivan, 'Materiality of Predictive Information after Basic: A Proposed Two-Part Test of Materiality' (1990) *University of Illinois Law Review* 207 at 207; Victor Brudney, 'A Note on Materiality and Soft Information under the Federal Securities Laws' (1989) 75 *Virginia Law Review* 723 at 723-724; Besorai, above n 27, at 244.

[25] Besorai, above n 23, at 245; Brudney, above n 24 at 723.

[26] Besorai, above n 23, at 245; Bodie, Zvi, Kane, Alex and Marcus, Alan J, *Investments* (Sixth edition, 2005) at 607.

information that contributes to materiality: significance.[27] From this analysis, two features of information may affect materiality; its reliability and its significance.

B. Material information under the new market fairness regime

Material information is defined in the SMAA as information that:

1. A reasonable person would expect, if it were generally available to the market, to have a material effect on the price of listed securities of the public issuer;[28] and
2. Relates to particular securities, a particular public issuer, or particular public issuers, rather than to securities generally or public issuers generally.[29]

1. A material effect on the price of securities?

Many insider trading regimes contain a requirement that the inside information in question is material.[30] Where information is clearly not generally available, materiality will be the sole concept to sort illegal insider trading from legal trading.[31] Three tests can be identified: the reasonable investor test, the probability/magnitude test, and the market impact test.[32]

(a) The market impact test

The market impact test measures materiality by the information's impact on the share price.[33] This raises the question whether any impact however insignificant can qualify as material under the market impact test? If this proposition is accepted then virtually any factor

[27] Emerging Markets Committee of the International Organisation of Securities Commissions, *Insider Trading: How Jurisdictions Regulate It* (2003) at 3.
[28] SMAA section 3(a).
[29] SMAA section 3(b).
[30] Ministry of Economic Development, *Reform of Securities Trading Law: Volume One Insider Trading, Discussion Document,* (May 2002) at 39; Emerging Markets Committee of the International Organisation of Securities Commissions, above n 27 at 2.
[31] Joan MacLeod Heminway, 'Materiality Guidance in the Context of Insider Trading: a Call for Action' (Annual 2004) 52 *American University Law Review* 1131 at 1148.
[32] Ministry of Economic Development, above n 30 at 39**;** Gordon Walker, Brent Fisse, and Ian Ramsay, (eds), *Securities Regulation in Australia and New Zealand* (1998) at 606;
[33] Ministry of Economic Development, above n 30 at 40.

influencing a person to buy or sell could qualify as "material" because almost all large trades will influence a share price slightly.[34] This does not sit well with the wording of the SMAA. The section reads "a reasonable person would expect, if it were generally available to the market, to have a *material* effect on the price of listed securities".[35] If the test for materiality was any change in price "material" in the above definition would be superfluous.[36] A minimum threshold must be found.

(b) The reasonable investor test

This test measures materiality of information by the importance a reasonable investor would assign it.[37] The US test for materiality, established in the case of *TSC Industries v Northway Inc*[38] (the "TSC test"), is: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[39] Under the *TSC* test the information need not actually change the decision of the shareholder when voting[40] it is enough the information "assumed actual significance in the deliberations of the reasonable shareholder".[41]

It has been suggested this test is wider than the other materiality tests.[42] What becomes crucial is deciding what level of influence the information must have on the shareholder or investor. Voting and buying or selling shares are distinct actions and imply different levels of materiality. Also the decision of whether to buy or sell could vary depending on the investor's style. In *Leadenhall*[43] a distinction was made between short and medium term investors, and long term investors.

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[34] Bodie, Kane, and Marcus, above n 26, this phenomenon is called price impact.
[35] SMAA section 3(a), emphasis added.
[36] Emerging Markets Committee of the International Organisation of Securities Commissions, above n 27 at 4.
[37] Walker, Fisse, and Ramsay, above n 32, at 606; Ministry of Economic Development, above n 30 at 39.
[38] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132.
[39] Ibid.
[40] Ibid.
[41] Ibid.
[42] Emerging Markets Committee of the International Organisation of Securities Commissions, above n 27 at 4.
[43] *Leadenhall Australia Ltd v Peptech Ltd* (1999) 33 ACSR 301.

This is because short and medium term investors would find it significant that a large portion of shares were coming out of escrow in the near future. They would be likely to wait until that had occurred to measure the effect on the share price. However for long term investors the evidence of materiality was more equivocal.[44] If this test is to be used the courts should make explicit the required effect on the investor.

(c) The probability/magnitude test

The probability/magnitude test balances the probability an event will occur with the magnitude of the event for the company if it does occur.[45] In *Texas Gulf Sulphur*[46] the test was laid out: "In each case, then, whether facts are material ... will depend at any given time upon a balancing of both the indicated probability that the event will occur and the anticipated magnitude of the event in light of the totality of the company activity."[47] This test is particularly useful for measuring soft, predictive information because it takes account of the uncertainty in the information (by looking at the probability something will eventuate), and the significance of the information (by looking at its magnitude).

The tests have two features in common: they seek to evaluate the significance of the information and the reliability of the information. These two features are relevant to an assessment of all types of information whether it is hard (objectively verifiable or measurable), soft (subjective or impossible to objectively measure), backward, or forward looking. Its "significance" covers:

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

The "reliability" of information covers:

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[44] Ibid.
[45] Walker, Fisse, and Ramsay, above n 32, at 606; Ministry of Economic Development, above n 30 at 39; *Basic Inc v Levinson* (1988) 485 US 224.
[46] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[47] Ibid. at 849.

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

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

C. The approach to materiality in a fiduciary regime

Coleman was the first case to expressly adopt a test for materiality in New Zealand, and in *Coleman* it is clear that fiduciary duty underpins the definition of materiality. *Coleman* adopts the *TSC* [48] test for materiality and displays a true "reasonable investor test".

Cooke J stated the test as "those considerations which can reasonably be said, in a particular case, to be likely materially to affect the mind of a vendor or purchaser".[49] The *TSC* test[50] was expressly adopted in support. It is clear a high level of disclosure was required. The inherent nature of the fiduciary duty required the utmost candour.[51] Cooke J rejected that the mind of the purchaser had to be dominated by the vendor (the directors).[52]

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

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[48] *TSC Industries v Northway Inc* (1976) 426 US 438,449.
[49] *Coleman v Myers* [1977] 2 NZLR 225 at 334; *Hatrick v Commissioner of Inland Revenue* [1963] NZLR 641.
[50] Above n 48 at 2132.
[51] *Tufton v Sperni* [1952] 2 TLR 516 at 520.
[52] Above n 49 at 332

1. "Materiality" in the US

(a) The TSC test

TSC was an action brought by a shareholder (Northway) claiming that TSC's proxy statement was materially misleading in violation of the Securities Exchange Act section 14(a).[53] Northway argued that the statement was incomplete, therefore misleading because it failed to state that this prior transfer of interests in TSC had resulted in a change of control.

On materiality, the Court stated that it is "universally agreed"[54] the question is one involving the significance of an omitted or misrepresented fact to a reasonable investor. The Court also recognised that "variations in the formulation of a general test....occur in the articulation of just how significant a fact must be or, put another way, how certain it must be that the fact would affect a reasonable investor's judgment."[55]

The Court settled on the following test: "An omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[56] The proxy statement contained some information about the control of TSC, for example it was "prominently displayed" that National owned 34% of the shares and that 5 out of 10 TSC directors were National nominees. In these circumstances it could not be said that the omission of a statement expressly identifying the chairman of the board, or the omission of a statement explaining that National "may be deemed a parent of TSC" was a material omission as a matter of law.[57]

Despite being predominantly a "reasonable investor" test, *TSC* combines elements the market impact test. The Court stated further that a fact would be material if it altered the total mix: [58]

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[53] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at page 2128.
[54] Ibid at 2130.
[55] *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2130; *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 2132.
[56] Above n 53 at 2132
[57] Above n 53 at 2138.
[58] *TSC Industries v Northway Inc* (1976) 426 US 438,449 2132.

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

To determine whether the total mix has been significantly altered, courts have frequently resorted to evidence of price movements to ascertain the significance of the information.[59] Therefore *TSC* leaves room for the application of market impact factors to supplement an argument that the information was material.

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

US courts and commentators treat information about mergers differently to other types of predictive information and therefore use a different materiality test. Commentators have distinguished this type of information from other types of soft information on the basis that the existence of the possibility of a takeover or merger can be so significant that regardless of its probability it is a hard fact representing a present state of affairs.[60] Brudney distinguishes information about possible mergers and takeovers from the previous information due to the fact the information does not itself contain any especially knowledgeable estimates of the likelihood that the contingent events will occur.[61] Brudney suggests this information is analytically like many other forms of information, for example statement of expenditures made on research and development. This information expresses corporate estimates of contingent events but does not embody "express inferences about intermediate components of, or ultimate effect on, price."[62] The information simply "informs about the possibility that is likely to be of importance to an investor".[63]

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[59] Lee, above n 2, at 655.
[60] Sullivan, above n 24, at 221.
[61] Brudney, above n 24, at 723.
[62] Ibid.
[63] Ibid.

Basic Inc v Levinson[64] adopted the *TSC* test in a case of insider trading leading up to a merger. Sellers of stock during the period prior to the formal announcement of a merger alleged that material misrepresentations had been made because Basic had denied the existence of merger negotiations prior to this official announcement. Following this it was revealed that the company had been approached and the following day the board endorsed Combustion's offer of $46 per share.

The Court in *Basic* rejected that information about mergers should not have to be disclosed until an agreement as to price and structure had been made.[65] The Court expressly adopted the *TSC* test. The Court also cites the probability/magnitude test set out in *Texas*. The Court emphasised that, the existence of merger negotiations could be so important in a small corporation that information to this effect becomes material at an earlier stage than other types of transactions. To determine the probability element, the Court suggested the following will be relevant: signs of interest in the transaction in the highest corporate levels[66] such as board resolutions, instructions to investment bankers and actual negotiations between principals. To determine the magnitude of the transaction factors such as the size of the two corporate entities, and the potential premiums over market value will be relevant.[67] However no particular event or factor is necessary by itself to render information material.[68] In conclusion the Court stated "as we clarify today, materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information",[69] thus enforcing that the "reasonable investor" standard is still the dominant test.

The US materiality standard contains no requirement the information would actually make the insider trade. Also, the US standard includes qualitative information that would not necessarily affect the company's share price. The US courts seem to distinguish merger information from other types. In the context of mergers the high significance of the

[64] *Basic Inc v Levinson* (1988) 485 US 224.
[65] Ibid at 984.
[66] Ibid at 987.
[67] Ibid.
[68] Ibid at 987.
[69] Ibid at 988.

existence of negotiations overrides the reliability element. The *TSC* test is still accepted as the relevant legal standard to judge materiality.[70]

2. How was the fiduciary rationale expressed in the SMA?

Under the SMA there was no express requirement for a fiduciary relationship to be established between the insider and the person with whom he or she trades.[71] However, the influence of the fiduciary theory is clear from the requirement the offender must be an "insider"[72] and receive the information by reason of his or her position as an insider.[73] By requiring that a person is a true "insider" of the company, and has the information by reason of his or her position, the Act deems a fiduciary-like relationship to exist between the insiders and the person with whom they trade.[74]

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

3. Materiality under the SMA

The Commission's Report to the Minister of Justice did not recommend the use of the word "material" to define inside information.[75] The Report described the approach to inside information in the following way: [76]

> It is a difficult question to decide whether any particular item of information has affected prices or is likely to affect them. Those are matters of opinion. They are, we think, proper questions for resolution on the evidence of experts familiar with the market. If the evidence becomes disclosed to the market, evidence of a market reaction should be admissible and would, we believe, have a strong effect upon the result of a disputed

[70] "SEC Staff Accounting Bulletin 99", August 12 1999, 17 CFR Part 211.
[71] Ratner, P and Quinn, C, *Insider Trading, New Zealand Law Society Seminar* (1990), at 1.
[72] SMA section 3.
[73] SMA sections 3(b), (d) and (f).
[74] Securities Commission, *Insider Trading: Report to the Minister of Justice* (1987) at paragraph 1.4.
[75] Securities Commission, above n 74 at 38.
[76] Securities Commission, above n 74 at 8.

> case. If the information does not become disclosed to the market, the likelihood of a price reaction if the market had known is debatable. That likelihood should be assessed by applying robust common sense aided by expert evidence. Powerful considerations would be the nature of the information, the lapse of time, and intermediate announcements and price movements.

However, subsequently the word "material" was included in the SMA in the definition of "inside information".[77] Although little trace of the underlying fiduciary basis can be found in the Commission's suggestions above, it must be remembered this proposed test, (an analysis of the nature time and intermediate and subsequent price movements) is to apply where a link to the company has been established. The fiduciary theory has already done work by ensuring the person is an insider, and that they received the information by virtue of that position.

It was clear under the SMA there was no requirement for a prosecutor to "establish affirmatively" any state of mind on the part of an insider.[78] Therefore in *Wilson Neill* the fact the company directors had not analysed the material containing the inside information was irrelevant to liability.

The courts have been willing to look at the potential for price movement or actual subsequent price movements, utilising the market impact test. In *Kincaid*[79] Henry J focussed on the likelihood the information would impact the share price, rather than focusing on the influence on the reasonable investor.[80] The level of impact on the share price necessary to meet the material threshold is not clear from this judgment. However the Commission's report into the dealing said "on any measure a 55 million net influence is material."[81] Henry J concluded the information was probably material despite a number of

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[77] SMA section 2.

[78] Securities Commission, above n 74 at 37, 4.9.5(b); *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152.

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

[80] Ibid. at 23.

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

experts giving evidence to the contrary. The experts argued that since the users of the accounts would be able to see the general trend in the company's performance (the company had recovered slightly from 1989 position) the fact this recovery was overstated would not be significant. This approach stressed the effect on the users of the accounts, stating they would not be misled.[82] The approach was akin to the "reasonable investor" test however Henry J clearly favoured the market impact approach.

In *Wilson Neill* the CA clearly favoured a market impact test to establish materiality. The CA stressed "price sensitive" actually meant "price material".[83] The CA (preferring a "real or substantial risk"[84]) stated a "bare possibility" of a price movement did equate to "likely" but this did not clarify the significance of the price movement required.

The influence of a market impact test was also evident in the Commission's Regal Salmon Report.[85] In this report the news of a loss of $3.36 million "took the market by surprise"[86] and the share price dropped from 147 cents to 115 per share[87] (a movement of approximately 22%) and eventually traded as low as 72 cents. The Commission held there were material overstatements, according to accounting standards, in the financial reports prior to the report that caused the share price drop.[88] Despite this the Commission found Shagin, the director who had sold shares after the release of this materially overstated report, did not possess material information because he had not undertaken a skilled analysis of the data.

The market impact test was once again dominant in the Commission's

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[82] Above n 79 at 21:"He gave the opinion that users of the 1990 accounts would not be misled because they would see the results were still a long way less than the profits of 1987 and 1988, but with a recovery from the 1989 position."
[83] *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 161.
[84] Ibid.
[85] Securities Commission, *Report of an Enquiry into Aspects of the Affairs of Regal Salmon Limited Including Trading in Its Listed Securities* (July 1994).
[86] Ibid.
[87] Ibid.
[88] SSAP No 6 *Materiality in Financial Statements* (revised 1985) affirmed by the Accounting Standards Review Board in a release of 10 November 2000 (release of ASRB Release 7 *Accounting Standards that Still have Authoritative Support Within the Accounting Profession* (issued 11/00).

Fortex Report.[89] The Commission took account of the drop in the share price of 43 cents to 7 cents following the announcement of a 40 - 45 million dollar loss.[90] Amongst the information analysed was the fact of the appointment of an independent investigation accountant, Mr Stiassny. This had been communicated to Fortex's farmer suppliers. On this information the Commission commented, "We think that news of an appointment of such a person in such a position might also have acted as a signal to investors that all was not well with Fortex." The Commission only went as far as saying this was potentially price sensitive. It is unclear what "test" of materiality the Commission is using. However the reference of "signal to investors" perhaps indicates a reasonable investor standard. The Commission also looked at the fact the company had lost 16% market share, saying "a number of variables exist that leave unclear the question of how the market would react to this information. Was the loss of market share recoverable? How significant was the loss of market share given the supply of lambs in the season to date had been well below what Fortex had expected? How sensitive to market share did other share analysts consider Fortex's profit to be?"[91]

In *Haylock*[92] the market impact test was clearly influential although once again it is difficult to ascertain a threshold for the degree of impact necessary. When assessing the materiality of the information[93] Gault P stated "it will be difficult to contend that the information would not have been price-sensitive when the receipt of new licenses for un-investigated areas was seen as justifying an increase in the price offered for the shares".[94] Gault P accepted there are difficulties with respect to disclosure in the gas and exploration industries. He stated "that may bear heavily on aspects of the claim, for example any assessment of loss involving notional disclosure would need to take account of the reservations or qualifications that would be necessary to ensure only appropriate impact on share values. The lure of hindsight, often

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[89] Securities Commission, *Report on an Inquiry into Aspects of the Affairs of Fortex Group Limited (In Receivership and Liquidation) Including Trading in Its Listed Securities* (October 1995) at paragraph 12.19.
[90] Securities Commission, *Fortex Report,* above n 89, at 3.6.
[91] Securities Commission, *Fortex Report,* above n 89 at 12.21.
[92] *Southern Petroleum v Haylock* [2003] 3 NZLR 518.
[93] Ibid.
[94] *Southern Petroleum v Haylock* [2003] 3 NZLR 518 at paragraph 63.

attractive to claimants, must be resisted."[95] This indicated a clear willingness to look at share price impact to measure materiality and recognises that only the movement in share price attributable to the information itself should be taken into account.

In the Commission's Fletcher Challenge Report,[96] the information was a draft press release revealing "FCL management were considering options for a possible merger of FCL Paper with Fletcher Challenge Canada".[97] On materiality the Commission commented: "it seems clear that an announcement that a company is considering a major restructuring of one of its divisions is likely to materially affect the price of the shares of that division. This is so whether the release is known to be a draft document or a final news release, and whether there has been speculation in the market on these matters. An authoritative statement from within FCL on the subject would be an important event."[98] This analysis puts weight on the source of the information (the fact it was a draft from within the company) highlighting its increased reliability. The Commission also looked at the subsequent price movements of FCL shares.[99] After a halt on trading due to the leakage of the information, the share price peaked at 13% higher than when trading restarted, before dropping to a level 6% higher than at the start of the trading halt. The price then dropped sharply on 11 May at $1.68 (2.3% below the level before the trading halt). The Commission found this effect to be material. Clearly this was based on a market impact test.

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[95] *Southern Petroleum v Haylock* [2003] 3 NZLR 518 at paragraph 67.

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

[97] Securities Commission, *Fletcher Challenge Report,* above n 96, at 19.

[98] Ibid.

[99] The week of 26 to 30 April saw FCL Paper share prices rise on very heavy trading from around $1.43 at the start of the week to close the week on $1.67 (a rise of around 17% in 5 days). The following week the price rose to $1.75 before falling back to around $1.72 at 2 pm on Friday 7 May. Ibid, at paragraph 56; after the release of the leaked page to stockbrokers at 2 pm on the Friday the price of these shares began to rise further. The price peaked at $1.94 at around 10 am on Monday 10 May (a rise of about 13% in a little over 2 trading hours) before dropping to close at $1.82 (up 6% on the 2 pm price for 7 May). The price continued to drop sharply on 11 May, closing at $1.68. Securities Commission, *Fletcher Challenge Report,* above n 96, at 58.

In *Midavia*[100] the Court displayed a clear preference for the market impact test stating "because much inside information, such as the issuer's results being unexpectedly better or worse than earlier publicly forecast- will rapidly become public and bring in its train an impact on the price of the issuer's securities".[101]

In *Wilson Neill*, and *Kincaid* the market impact test is clearly dominant and is preferred over evidence based on standards that are more akin to a "reasonable investor" analysis. This is further supported by the Commission's reports into Gulf Resources, Regal Salmon, Fortex. The more recent statement by the Commission in the Fletcher Challenge Report further enforces the dominance of market impact as they were able to conclude materiality on a temporary, equivocal, share price movement. The most recent New Zealand insider trading cases, *Haylock* and *Midavia*, provide little discussion of materiality however statements of the courts seem to take for granted the appropriate approach is "market impact". Regardless of the approach taken by the courts to materiality, the cases do little to resolve the two important thresholds that are common to all materiality tests, the significance threshold and the reliability threshold.

D. The approach to materiality in a market fairness regime

The market fairness approach represents the idea that all participants in a market should have equal access to information about a public issuer.[102] If investors feel the market is unfair the flow-on effect will be a decrease in the amount of money people will invest, therefore increasing the cost of capital.[103] "So long as insider trading serves as an indication of the character of the securities market, 'fairness' is likely to have economic consequences through the reaction of investors and must be taken into account in any attempt to predict or enhance the market's efficiency".[104]

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[100] *Securities Commission v Midavia Rail Investments BBVA* [2007] 2 NZLR 454.
[101] *Securities Commission v Midavia Rail Investments BBVA* Unreported, High Court, Auckland, CIV-2004-485-2174, 28/9/05, Williams J at paragraph 86.
[102] Securities Commission, above n 79 at 15; Michael Gething, 'Insider Trading Enforcement: Where Are We Now and Where do We Go From Here?' (1998) 16 *Company and Securities Law Journal* 607 at 608.
[103] R *v Doff* [2005] NSWCCA 119 at [56]; *Regina v Rivkin* [2004] NSWCCA 7.
[104] Phillip Anisman, *Insider Trading Legislation for Australia: An Outline of the Issues and Alternatives. An Issues Paper prepared for the Working Party on Insider Trading of the National*

The market fairness rationale is evident in the Australian legislation as there is no requirement that the insider is connected to company. The Australian section 1042D of the Corporations Act reads: [105]

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

Materiality under the market fairness rationale utilises a combination of the three tests: reasonable investor, market impact, and magnitude/probability. One recurring feature is the absence of any sensitivity to the different types of information that can arise. As a result the materiality analysis is much cruder than the analysis in the US. Also in a couple of instances the obvious choice of test (the probability/magnitude test where information is forward looking) is ignored and subsequent share price movements are used instead.

The reasonable investor approach is present in the background of all the cases due to the wording of the materiality definition. However, the courts do not seem content to rely on the reasonable investor test alone, using the market impact or magnitude/probability tests to supplement it. Many cases equate the reasonable investor test with "price sensitivity". This indicates the Australian courts' view the reasonable investor test as more restrictive than the wide approach of the US courts where qualitative information can be included. For example in *Ampolex,*[106] Rolfe J said "one must ask whether such a reasonable person would expect that the intention, being an intention of persons who hold a parcel of the convertible notes to so advise the ASX could or would be likely to influence the designated persons"[107] but then Rolfe J equated this requirement with "price sensitivity" returning to a market impact analysis.[108]

Companies and Securities Commission (1986) at 9.
[105] Corporations Act 2001, section 1042D.
[106] *Ampolex Ltd v Perpetual Trustee Co (Canberra) Ltd* (1996) 20 ACSR 649 at 1523.
[107] Ibid.
[108] Ibid.

In *Evans v Doyle*[109] the material information was the test results of mineral exploration. Mt Kersey Mining NL held licenses to mine the land adjoining where test results had discovered a shoot of high-grade nickel sulphide.[110] The discovery was significant in the mineral grade, but was un-quantified. However, the discovery suggested the minerals extended onto the company's land. This information falls squarely within the category of soft predictive information. The outcome of the information on the fortune of the company was uncertain despite its potential to be significant. Evidence was admitted to illustrate the impact of the information on the price of the shares once the information was disseminated.[111] Surprisingly on facts broadly similar to *Texas Gulf* in the US,[112] there was no attempt to analyse the information in terms its probability/magnitude. The Court ignored the subtleties of the types of information that can occur in favour of market impact evidence.

Rivkin[113] was the first prosecution of an "outsider" under a market fairness regime and illustrated how "materiality" would operate where there was no connection to the company.[114] Mr Rivkin wished to sell his house, and instructed a real estate agent, Doff to act on his behalf. Mr McGowan, Executive Chairperson of Impulse Airlines was interested in purchasing the house. He approached Doff and eventually spoke to Rivkin in a phone conversation on 24 April 2001 in which he revealed information about his company's affairs. He explained to Rivkin he wished to make the purchase conditional as he was waiting to "merge" businesses with Qantas. Rivkin expressed disbelief that the company's would get the necessary regulatory approval, but was reassured by McGowan. Further McGowan warned Rivkin he could not now trade in the Qantas shares. Following the conversation Rivkin purchased 50 000 Qantas shares. On 1 May 2001 on Rivkin's instructions the shares were sold making a profit of $2664.94. Later that day the merger was announced and there was a significant rise in the price of Qantas shares.

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[109] *R v Evans & Doyle* [1999] VSC 488 (15 November 1999).
[110] Ibid.
[111] *R v Evans & Doyle* [1999] VSC 488 (15 November 1999) at 548.
[112] *SEC v. Texas Gulf Sulpher Co* 401 F.2d 833 (2d. Cir.1968).
[113] *Regina v Rivkin* [2004] NSWCCA 7; see also *R v Doff* [2005] NSWSC 50.
[114] Juliette Overland, 'The Future of Insider Trading in Australia: What Did Rene Rivkin Teach Us' (2005) 10 *Deakin Law Review* 708 at 709.

Rivkin established the source of information can be included in the information itself.[115] It was argued the information possessed was not the actual state of affairs conveyed but was the fact that Mr McGowan had stated that such a state of affairs existed. This was rejected because it was held a person need not believe the underlying state of affairs to be true (the essence of the argument against including this information). The Court considered a number of expert opinions that expressed the source of the information would be crucial to its reliability and therefore its materiality:[116] "It was also abundantly clear that the circumstance that Mr McGowan was the source was relevant to the question of the reliability of the information, and hence its materiality."[117]

In the US the question of the source of the information is distinct from materiality. For example, an outsider who receives the information from an insider is required to know that it is being disclosed in breach of confidence.[118] This requirement was expressly rejected in *Rivkin* as it was held there was nothing in the legislation to suggest such a requirement.[119] This creates a challenge for materiality determinations as there is now a third feature to analyse. Strangely the arguments to support this proposition were based on the idea that to allow such an argument would allow insiders to avoid the scheme where the source is reliable but a mere rumour was conveyed. It was acknowledged that the market "operated on matters of sentiment, rumour and tips"[120] therefore this type of situation should be covered by insider trading law. The main problem with such an assertion is that in most cases "sentiment and rumour" in the market contains only information that is generally available and therefore not material.

Petsas[121] involved merger negotiations; however, unlike the US approach a probability/magnitude test was not expressly addressed. The information was confirmation of the existence of confidential

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[115] *Regina v Rivkin* [2004] NSWCCA 7 at paragraph 131.
[116] Ibid. at paragraph 51 and paragraph 73.
[117] Ibid. at paragraph 137.
[118] *Chiarella v. United States* (1980) 445 U.S. 222.
[119] Above n 115 at paragraph 139.
[120] Above n 115 at paragraph 72.
[121] *ASIC v Petsas & Miot* [2005] FCA 88; [2005] 23 ACLC 269.

merger negotiations between BRL Hardy Ltd and Constellation Brands, and confirmation that ANZ had been engaged by BRL to perform work in relation to this merger. The Court recognised "because of their tentative nature the discussions were highly confidential". However this "soft" quality of the information did not factor into the Court's materiality analysis. The Court stated "Mr Petsas and Mr Miot knew that if the information about the merger discussions became public it would affect the price of BRL's shares as well as the price of the call options over those shares."[122] Under the US approach this information would have also been material because Constellation Brands Inc is one of the world's largest producers and suppliers of alcohol. Because of its relative size, the existence of negotiations would be a significant fact to a shareholder regardless of the level of probability that they would eventuate into a merger. The US Court would have reached this conclusion by looking at the information from the perspective of a reasonable investor. However the Court skipped an analysis of this kind. The strong evidence of market impact made it unnecessary to elaborate. When the information was released the stock price rose immediately by around 17% and continued to rise.

Hannes[123]demonstrated a mixed approach to materiality equating the reasonable investor test with the market impact test. The Court summarised its approach stating: [124]

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

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

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[122] Ibid. at paragraph 7.
[123] *Hannes v Director of Public Prosecutions* (Cth) (No.2) [2006] NSWCCA 373.
[124] Ibid. at paragraph 384-385.

Because of the way the information was particularised there was considerable objection to the use of evidence of the share price movement of the announcement of a takeover at $2.45. It was argued that the evidence of what actually occurred on the day of the announcement was information of a "qualitatively different nature" than the information particularised (the "possibility of a takeover at a price above $2.01"). When evaluating whether the particularised information was generally available the Court found "there is a difference for example, between speculation as to a 'takeover valuation', on the one hand, and information as to the likelihood of a particular takeover, on the other. It was the combination of the information particularised which was significant in relation to the offence charged."[125] The Court held these differences did not mean the evidence of what actually happened was irrelevant to materiality.[126] The Court clearly favoured the evidence of share price movements over other evidence stating: [127]

> The possibility that other factors may have affected the market for a particular security at a particular time must always be borne in mind, but to reject information as to price movements out of hand on that basis is at least to risk inviting the jury to speculate, without the assistance of the only concrete evidence of which might be thought to provide some assistance in undertaking that evaluation.

So despite the Court's recognition that it was applying a reasonable investor test it relied heavily on market impact evidence.

Significantly, in *Hannes* the Court was directed to US authority[128] in an attempt to limit the influence of evidence of share price movements. However the Court felt there were two important points of distinction to be made. Firstly the US cases dealt with whether a failure to disclose was misleading (as opposed to an insider trading case) "an issue to which any increase in the value of the stock after disclosure was clearly not compelling".[129] Secondly the US cases only described the evidence as of "limited value" which is different from saying it has no probative

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[125] Above n 123 at paragraph 382.
[126] Above n 123 at paragraph 299.
[127] Above n 123 at paragraph 351.
[128] *Reiss v Pan American World Airways Inc* 711 F.2d 11 (2d Cir. 1983); *Securities and Exchange Commission v Texas Gulf Sulphur CO* 401 F.2d 833 (2d Cir. 1968) at 863.
[129] Above n 123 at paragraph 352.

value.[130] The Court commented, "it is readily apparent that the law in question in that case was a materially different form of insider trading prohibition to that with which the present charge is concerned, the reasoning nevertheless demonstrates that evidence of subsequent trading is treated in US law as potentially relevant to issues similar to that of "general availability" under Australian Law."[131]

In 2007, *Citigroup*[132] demonstrated the full dominance of the market impact test. The first insider trading claim failed because Manchee was not considered an "officer" of Citigroup and was not found to have made the supposition contended. It was argued that after the "cigarette conversation" in which his supervisor told him not to buy any more Patrick shares, Manchee formed an "un-communicated supposition" that the rumours about the takeover were true and that Citigroup was acting for Toll. The court went on to analyse the "price sensitivity" of this information. It was held that at the time of Manchee's sale, the market had already moved the share price to a level that reflected "the substantial likelihood" of a takeover. The further non-public information that Manchee held, that Citigroup was acting for the Bidder, was not material. The second insider trading claim failed because an effective Chinese wall was in place. However the materiality analysis undertaken by the court reflected a pure market impact test. The information was the knowledge that Citigroup was acting for the Bidder, and the timing of the announcement of the takeover bid. Before the start of trading on Monday, the takeover was announced to the market. The court found it was likely knowledge of the timing of the release was material because the Patrick shares opened the day of the announcement at $7.19, 10.9% higher than the closing price the Friday before. This price rise, and the subsequent price rise to $7.38 seemed to establish the materiality of the information. The information in question (for the second charge) was "knowledge of the timing" of the announcement of the takeover by Toll. This was in an environment where the market contained such a high degree of speculation that it knowledge of the "substantial likelihood" of a takeover was generally available. The only factor relied on to establish the materiality of the above information was a price rise between the close of trading on

[130] Ibid. at paragraph 352.
[131] Above n 123 at paragraph 354.
[132] Above n 5.

Friday and the opening price of the stock after the announcement had been made early Monday morning. This is clearly a market impact test.

The test adopted by the Australian courts seems to be predominantly market impact despite section1042D suggesting a reasonable investor test. From the heavy emphasis on the share price movements and the repeated references to price sensitivity, it seems that the information must be of a kind that would actually induce the reasonable investor to buy or sell shares thereby creating a price impact. The Australian courts do not address the possibility that information that would create an impact once released might not be recognised as such by a reasonable investor prior to its release.

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

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

E. A comparison of the approaches.

1. Does the underlying rationale affect materiality?

Firstly, the threshold for materiality in Australia under a market fairness approach is more demanding than in the US because of the requirement the information would be viewed by the reasonable investor as likely to affect the share price.[133] At first it might be expected that in essence both tests are the reasonable investor test, therefore materiality should be the same. However the inclusion of the words "effect on price" in the Australian section (and consequently SMAA) is significant. It has led to the approach being closely aligned to

[133] Corporations Act 2001 section 1002(1)(2).

a "market impact" analysis, as the courts have viewed evidence of share price movements as highly relevant and sometimes determinative. The US test focuses more on the deliberative process of the investor. It does not demand that the information would have induced the investor to buy or sell but requires that it "assume actual significance" in the investor's deliberations.[134] Because the second limb of the *TSC* test refers to the "total mix" of information available, evidence of share price movements are admissible in the US but not determinative.[135] It has also been suggested by Cox that there is little difference in practice between the tests, but without evidence of more "hard cases" being determined by the courts in this area it is impossible to know.[136]

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

Thirdly, under the market fairness approach the source of the information blends into its materiality. It has been illustrated that the tests employed by the courts search for a threshold level of significance and reliability. Very significant information can be material despite a low level of reliability (for example the existence of merger discussions). Alternatively, very reliable information, with a low level of significance may well be material (for example a financial reporting error of 3%). The two features together determine materiality. However *Rivkin* adds a third element into the Australian analysis: reliability of the source of the information.

The importance of the source of the information is recognised in both fiduciary and market fairness regimes.[137] However under a fiduciary approach the "reliability" of the source of information is much more easily established. This is because the US cases all involve information

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[134] James D Cox, 'An Outsider's Perspective of Insider Trading Regulation in Australia' (1989-1990) 12 *Sydney Law Review* 455 at 470; *TSC Industries v Northway Inc* (1976) 426 US 438,449 at 449.

[135] *U.S.v. Bilzerian* (1991) Fed. Sec. L.R. 98283, 98290-98291.

[136] Cox, above n 134, at 470.

[137] Richard C Sauer, 'The Erosion of the Materiality Standard in the Enforcement of the Federal Securities Laws' (2007) 62(2) *Business Lawyer* 317(41) at 322.

that was sourced (albeit sometimes indirectly) from the company. The source of the information forms part of the threshold question of whether a duty exists: the trader needs to know that the information was received in breach of confidence to the owner of the information. This is particularly important in tippee liability. Because an insider knows they are already "inside" the company, and information that comes their way is probably reliable, it sends a clear signal to the insider to analyse the significance and reliability of the content of the information carefully. The materiality question is engaged after this initial determination of the source is made. As a consequence the "reliability" element in the US focuses on the actual measurable probability of the information occurring and its verifiability.

On the other hand under market fairness approach the reliability aspect of the information is more difficult to deal with. *Rivkin* demonstrates the "source of the information" is included in the information itself. Under the market fairness approach information's significance is largely dealt with using a market impact method, by resorting to evidence of the likelihood of price movements and their magnitude as opposed to asking whether a shareholder would consider it important. Taking such an approach means an inclusion of the source of the information in the market fairness approach substitutes for the "connection"[138] under a fiduciary approach. Because under a market impact approach there is a much wider range of circumstances that information may be imparted to an investor the reliability aspect takes on a new dimension: it must also analyse the circumstances in which the information arose. This makes finding a threshold even harder.

If the source of the information is included there is a possibility information insiders may elevate themselves to tippers where the bare information would not have been material. The facts of *Citigroup*[139] demonstrate this risk. An employee of a large investment bank speculates (forms an uncommunicated supposition) that his investment bank is working on a merger of two companies. There is already a large amount of speculation in the market that the two companies will merge to the point the market is relatively certain the event will take place in the near future. The identity of an advising firm would not by itself

[138] Alexander F Loke, above n 19.
[139] Above n 5.

provide any additional significant information to the market because, by itself, it does not confirm the firms will in fact merge only reasserts what is generally available that it is likely the firms will merge (and with that it is certain they will both have a firm acting for them). However if the employee conveys this supposition to someone, the fact it is information from within the advising firm elevates his speculation about the identity of the advising firm to a material fact and therefore is guilty of tipping. His own possession of that information would probably be unlikely to tip the balance of information in the market. Under a fiduciary regime the fact it came from within the firm would establish it was a breach of confidence, then the focus would be on whether or not the confirmation that that particular firm was acting for one of the parties was sufficiently significant to alter the total mix. However under a market fairness regime the source and the information are combined. The fact that it is from an "inside source" appears to concrete the reliability of the information and therefore makes it more likely the information will be material.

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

The source of the information is often an indication of whether the information is generally available. Under a fiduciary approach the source would relate to whether the tippee knows that the information is being communicated in circumstances that constitute a breach of duty. If the source and circumstances of receiving the information does not go to the availability of the information how can this be determined? Overland gives the example of three examples of information: [140]

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

Overland argues if you imagine a person overhearing the above

[140] Overland, above n 114, at 716.

information it becomes clear that the source of each piece of information forms a vital part of the information itself.[141] Without the inclusion of the source, each piece of information seems identical. However an alternative approach would be to look at the information as identical, but at different stages of availability: the first being clearly not generally available and the third probably common knowledge.

Overland commends the development in *Rivkin*. She argues speculation and rumour can have an impact on the price of securities and so people acting on rumour or speculation should also be caught by the regime.[142] However the real damage caused by rumour or speculation arises from an insider in breach of his or her duty to the company. Where, for reasons of commercial sensitivity, the information has been kept confidential such a tip could cause damage to the company's plans and therefore its current shareholders. However, sometimes rumour or speculation in the market (and trading on it) can be a good thing. If extensive enough to have an impact on the share price, speculation is usually "generally available", particularly where it has not originated from the company. In a number of cases "rumour" in the market has been admitted as evidence of what information was generally available.[143] Trading on such information often improves the accuracy of the share price meaning that official announcements often have a smaller impact on the share price than if there had been no leakage of the information. This reduces the opportunity for "real" insiders to take advantage of the information. Often rumours are the result of market analysts piecing together industry factors with the specific circumstance to accurately predict what might occur. *Citigroup* is a clear example of this as a high degree of speculation and rumour created by a number of objectively observable circumstances moved the share price.

New Zealand's poor record of insider trading enforcement[144] does not

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[141] Ibid.

[142] Ibid.

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

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

necessarily indicate a low level of insider trading: it can only be speculated to what extent the regime is actually complied with. Materiality prevents a more rigorous enforcement of the regime and also an obstacle to compliance with the regime. The New Zealand Business Round Table ("NZBRT") stated in its submission on the Bill: "If businesses are expected to pay for clarifying rulings or interpretations, some may be commercially driven to fly blind and risk technical non-compliance."[145] As a result the purpose of the insider trading law is frustrated.

F. Materiality as an obstacle to compliance

Underlying the Courts' reliance on the market impact test is the idea that the market is efficient.[146] Because the market is efficient, share price movements are an accurate measure of the significance (therefore materiality) of new information. Broadly put the Efficient Markets Hypothesis (EMH) means that share prices already reflect all available information about the value of that share. Therefore, because a share price already reflects all available information its price should only decrease or increase in response to the entrance of new information in the market.[147]

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

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

[146] Walker, Fisse, and Ramsay, above n 32 at 607.

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

Alister Alcock stated: [148]

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

If an experienced corporate financier is unable to predict what will happen on the disclosure of information, how then can the "reasonable person" be expected to do so? Even on the assumption that the sophisticated investor is the appropriate hypothetical person, it is clear that analysing materiality based on *ex post* share price movements provides no adequate guidance to insiders or outsiders who must decide whether to trade.

Another problem exists with the market impact test: it uses *ex post* price movements to establish the *ex ante* knowledge of the reasonable investor. However in *Citygoup*[149] there was an unwillingness to attribute the same "benefit of hindsight" to knowledge held by the market generally. When evaluating the expert evidence offered in *Citigroup* as to what information was held by the market generally, the Court held that the information available was "more persuasive after the event than it apparently was on 19 August 2005."[150] Further the Court stated: "Although Mr Harvey acknowledged that the absence of a report from Mr Smith may have triggered some of the activity in Patrick shares, this was a clue that was only available with the benefit of hindsight."[151] It seems extraordinarily inconsistent to give the market the benefit of the doubt as to whether the information was available, but to allow share price movements to be evidence of the "extra information" held by the insider.

The market impact test is unable to specify a minimum threshold of the

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[148] Alistair Alcock, 'Inside Information' in Barry Rider and Michael Ashe (eds), *The Fiduciary, the Insider, and the Conflict: a Compendium of Essays* (1995) at 89.
[149] *Australian Securities and Investments Commission v Citigroup Global Markets Australia Pty Limited* (ACN 113 114832) (No. 4) [2007] FCA.
[150] Ibid. at 963, paragraph 557.
[151] Ibid. at 963 at paragraph 562.

level of price movement required to establish materiality. Even if the direction of the movement of the share price can be predicted, the courts have not provided a minimum threshold for the magnitude of the share price movement. In a relatively illiquid market such as New Zealand, a large trade can move the share price up or down through price impact.[152] If no minimum threshold is provided, an institutional trader's knowledge that it is about to purchase a large block of shares could, on the market impact test, be material information. The NZBRT submissions on the market manipulation regime support this proposition describing how it is common for brokers to break up large orders to avoid price impact.[153] The practice of managing large orders in this way is evidence that large orders can create price impact. Prosecution for insider trading on such facts is unlikely[154] but it highlights a serious flaw in the market impact test as it is currently applied. If a market impact test is to be applied a minimum threshold price movement must be specified.

The market impact approach relies heavily on a contestable concept in modern securities markets: efficiency. Langevoort explains an irrational market reaction in response to media attention. On Sunday 3 May 1998 an edition of the New York Times ran a story about Entremed, a Biotech company that held licensing rights to a medical breakthrough. As a result of the increased media attention caused by the article the share price rose dramatically.[155] Langevoort reveals this article contained no new information, everything had already been disclosed in previous Times articles and company releases. Therefore, the share price increase directly contradicts the EMH theory that share prices immediately impound all available information.[156]

Behavioural finance theory stems from the idea that market participants are influenced by psychological factors, not just fundamental values.[157]

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[152] Bodie, Kane, and Marcus, above n 26.
[153] New Zealand Business Round Table, *Submission to the Ministry of Economic Development on the Reform of Securities Trading Law* (2002) http://www.nzbr.org.nz/documents/submissions/submissions-2002/insider_trading.pdf (at 16 September 2007) at 11.
[154] SMAA section 9C.
[155] Langevoort, above n 147, at 70.
[156] Ibid.
[157] Donald C Langevoort, 'Theories, Assumptions and Securities Regulation: Market Efficiency Revisited' (1991) 140 *University of Pennsylvania Law Review* 851at 866.

Where investors play the game of second guessing what other investors will do, the traded share price can stray from its fundamental value. The problem this raises for materiality is that it is not clear whether the tests assume investors make decisions based on fundamental value or whether the tests allow room for this speculative element.[158]

Commentators have reflected this uncertainty without explicitly recognising the link to the behavioural finance theory. The market reaction to information has been labelled too crude to reflect a hypothetical reasonable investor's reaction: [159]

> Holders of a small amount of a company's securities may have different priorities than institutional investors and thus react differently to particular corporate developments. That holders of a small number of company's shares do not act in numbers sufficient to affect stock prices does not make their views unreasonable....Given that the great bulk of securities transactions are now made by institutional investors, to say otherwise would make the 'reasonable investor' synonymous with the well-funded money manager.

If all investors reacted in an economically rational way to information, sophisticated, unsophisticated, large, and small investors would react the same way but it is clear they do not. Richard Sauer highlights a well known bias that investors react disproportionately to a change in news:[160]

> Even when a company's disclosure is, clear, complete, and can be isolated from all background noise, market reaction may not provide a perfect measure of its materiality. The very event of a corrective disclosure of a previous misstatement, for example, may seem more significant to investors than the substance of the disclosure if the disclosure gives rise to investors' fears of civil or criminal liability or it is suspected to be the first instalment of what will likely be a series of escalating abd news items.[161]

Another example of behavioural finance at work is the phenomenon of price momentum.[162] Simplified this is the theory that good or bad

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[158] Ibid. at 866.
[159] Sauer, above n 137, at 325.
[160] Bodie, Kane, and Marcus, above n 26.
[161] Sauer, above n 137, at 325.
[162] Narasimhan Jegadeesh and Sheridan Titman, 'Returns to Buying Winners and Selling Losers: Implications for Stock Market Efficiency' (1993) 48 *Journal of Finance* 65.

recent performance of particular shares continues over time without any new information being released to the market. This defies the EMH claim that subsequent price movements are independent of their antecedents.[163] For example in the instance good news is released to the market, a slow upward trend in the share price following the announcement suggests the initial reaction was an under reaction and the price is slowly adjusting. An instant but excessive reaction leading to a downward trend suggests the initial response was an overreaction.[164] This is called the overreaction effect.[165] The overreaction effect has been evident in share price movements relied on in several instances to establish materiality. For example the Securities Commission, in its *Gulf Rescources Report,*[166] found evidence of a settling in the price of the shares after the initial announcement. The shares rose briefly from a 40-45 cent range up to a 48-50 cent range, and then fell to a 43-48 cent range two days after the announcement. Also, in its *Fletcher Challenge Report*[167], the Commission found that the leaked page had a material effect on the price of Fletcher Challenge shares even though the market initially overreacted. After the release of the leaked page to stockbrokers at 2 pm on the Friday the price of these shares began to rise. The price peaked at $1.94 at around 10am on Monday 10 May (a rise of about 13% in a little over 2 trading hours) before dropping to close at $1.82 (up 6% on the 2 pm price for 7 May). The price continued to drop sharply the next day, closing at $1.68. These reports show how, if overreaction factors are not taken into account when using a market impact test, potential exists for unfairness to an investor who cannot predict the severity of the market's reaction.

Citigroup[168] provides a good example of where reliance on EMH theory might lead to a flawed measure of the materiality. The 10.9% increase in the share price over the weekend could have been explained by a momentum effect of the information that was generally available on the Friday; that there was a "substantial likelihood" of a takeover. If so, the

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[163] Langevoort, above n 147, at 72.
[164] Ibid.
[165] Ibid.
[166] Securities Commission, *Report on Enquiry into Dealings in the Voting Securities of Gulf Resources Pacific Limited (Formerly City Realities Limited) During the Period November 1989 to January 1990* (June 1992).
[167] Securities Commission, *Fletcher Challenge Report*, above n 96.
[168] Above n 5.

price movement is unreliable evidence of the materiality of the knowledge of the timing of the announcement because it might be a result of this momentum effect not the release of the timing of the announcement.[169] In such circumstances it is difficult to define the extent to which the release of the information caused the further decline/increase in the shares value, as opposed to a general trend in the price due to the momentum effect.

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

Despite the increasing recognition of behavioural finance, the courts in Australia and New Zealand tend to ignore the other possible causes of share price movements when determining materiality.[170]Anomalies in the reaction of the market are not within the knowledge of the average investor. If the courts continue to use price movements to establish materiality of information they must begin to expressly recognise these anomalies and accommodate them. It is too much to ask that the average investor know of these anomalies therefore a strong case exists to limit the application of such a test to insiders who possess a higher degree of knowledge of the market.

F. Materiality: an obstacle to enforcement of insider trading

The cases do not display a clear threshold of the significance or reliability required for materiality. This is an obstacle to enforcing insider trading as regulatory bodies are only going to pursue clear cases.

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[169] *Re Wilson Neill Ltd; Colonial Mutual Life Assurance Society Ltd v Wilson Neill Ltd* [1994] 2 NZLR 152 at 153.

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

This is supported by Gething who suggests three main problems face ASIC in trying to prosecute insider trading.[171] These are: the difficulty of detection, the problem of proving knowledge, and the necessity to rely on expert evidence to prove materiality.[172] Similarly Tomasic lists the "materiality" issue as one of nine obstacles to enforcement of insider trading.[173]

Cox argues that the American prosecutions for insider trading have not been hindered by findings that the information was not material.[174] He argues that the essence of insider trading is the fact that the trader has in fact profited from the trading, and argues that no prosecution has been initiated against the bumbling insider trader.[175] Several commentators have related the success of insider trading enforcement in the US to its less technical anti fraud provision.[176]

G. How the fiduciary connection reduces obstacles to enforcement and compliance

A market fairness rationale creates an over inclusive insider trading regime that puts greater pressure on a materiality standard that is already difficult to apply and enforce. It forces materiality to assume a greater role in "sorting" illegal insider trades from legitimate trades. The Australian experience shows this is done for little gain. In Australia only one person who could be considered a true outsider has been convicted of insider trading.[177] Even in that case, Rene Rivkin was really an "insider" of the wider share market community in Australia.

The fiduciary connection reduces obstacles to enforcement and compliance by accommodating a lower materiality threshold. A lower threshold is acceptable in a fiduciary situation because the insiders have knowledge of their privileged position in terms of access to specially informed information. The insider has been given a signal about the

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[171] Gething, above n 102, at 618.
[172] Ibid.
[173] Roman Tomasic and Brendan Petony, *Casino Capitalism? Insider Trading in Australia* (1991) at 121.
[174] Cox, above n 131, at 470.
[175] Ibid.
[176] Tomasic, Roman, "Corporate Crime: Making the Law more Credible" (1990) 8 *Company and Securities Law Journal* 369.
[177] *Regina v Rivkin* [2004] NSWCCA 7.

potentially significant quality of any information obtained in this position. Because for an employee (insider) under the US "disclose or abstain rule" full disclosure of information is not a viable option, the rule amounts to the requirement the employee, completely abstain from trading. Langevoort stated: "that seems acceptable given that the position of the Court seems to be that classical insiders should not trade based on informational advantage gained as a result of their corporate positions."[178] This idea is equally applicable to New Zealand and justifies a more onerous restriction on insiders through a fiduciary approach.

Conversely, the market fairness approach increases obstacles to enforcement and compliance because it necessitates the use of a law that all market participants can follow and understand. For a materiality standard to be effective it must be accessible to even the most unsophisticated investor. There has been a complete refusal to adopt "bright line" rules on which people can base their trading decisions. It has been demonstrated that the unsophisticated investor has a limited ability to deal with the subtleties of price movements. It seems unfair to impose an ambiguous rule on the whole market for the sake of catching, in most cases, company insiders. A trade off must be made between adopting a stringent rule setting materiality at a low threshold for insiders under a fiduciary approach and allowing some outsiders to trade without consequences. Gething suggests the source of the information will usually be the company.[179] If this is correct, a prosecution under the market fairness approach should usually include at least one charge that would have been caught under the fiduciary regime anyway.[180]

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

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[178] Donald C Langevoort, 'The Muddled Duty to Disclose Under Rule 10b-5' (2004) 57 *Vanderbilt Law Review* 1639 at 1659.
[179] Gething, above n102, at 618.
[180] SMAA section 8D.

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

What is most important in an insider trading regime is boosting investor confidence. The perception that insiders are unjustly enriched by inside information has been labelled "corrosive".[181] The general public are not as offended by the idea that someone who stumbles across inside information by chance (for example the fax in the Fletcher Challenge Report) might make a profit. With this in mind the law should make it easier to enforce against those insiders not harder. As Stephen Franks suggested, instead of being extended the law should be more ruthlessly enforced.[182]

Conclusion: do insider trading laws matter?

There is a divergence in the underlying rationales for regulating insider trading in the US, Australia and New Zealand. It has been suggested that materiality is easier to establish in a legal setting under a fiduciary approach similar to the one taken in the US than the new approach adopted in the SMAA: a market fairness approach. This matters because where materiality can be easily established, it should follow that the whole insider trading regime is easier to enforce and comply with than where materiality is an unattainable standard.

This is important because the existence of insider trading laws does not matter unless they are enforced.[183] Evidence suggests that insider trading laws only have an effect on the cost of capital in a market (a good measure of confidence in the market) where they are enforced.[184] Also evidence exists suggesting that countries with more stringent insider trading laws have more dispersed equity ownership, more liquid

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[181] Saikrishna Prakash, 'Our Dysfunctional Insider Trading Regime' (1999) 99 *Columbia Law Review* 1491 at 1500.
[182] Stephen Franks, 'Parliament Must Tidy Up Primitive *New Zealand Herald*, 5 December 2000. Available at http://www.nzherald.co.nz/feature/index.cfm?c_id=729 (at 10 September 2007).
[183] Bhattacharya Utpal and Hazem Daouk, 'The World Price of Insider Trading' (2002) 57 *The Journal of Finance* 75.
[184] Ibid.

stock markets, and more informative stock prices.[185] However the stringency of the laws is irrelevant without enforcement. Therefore barriers to enforcement must be minimised to ensure insider trading laws reduce the cost of capital in New Zealand. If the law does not achieve this then the costs of compliance with this difficult standard will outweigh the benefits.

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

[185] Laura Nyantung Beny, 'Insider Trading Laws and Stock Markets around the World: An Empirical Contribution to the Theoretical Law and Economics Debate' (2006-2007) 32 *Journal of Corporation Law* 237 at 239.