MINISTRY OF BUSINESS, INNOVATION & EMPLOYMENT
HĪKINA WHAKATUTUKI

COVERSHEET

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21 February 2018	Regulatory Impact Summary: Application of Insider Trading Prohibition	MBIE

Information redacted **NO**

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Impact Summary: Application of insider trading prohibition

Section 1: General information

Purpose
The Ministry of Business, Innovation and Employment is solely responsible for the analysis and advice set out in this Regulatory Impact Analysis, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing final decisions to proceed with a policy change to be taken by Cabinet.

Key Limitations or Constraints on Analysis
This impact summary relates to the application of the insider trading prohibition to the primary market where shares and other financial products are first created and sold (rather than the secondary market where they are traded among investors). The analysis is largely based on impacts identified by submitters. The analysis includes some evidence on the size of the affected market, but quantitative evidence is limited as it is difficult to identify which transactions would likely be impacted by the proposal.
Responsible Manager
Authorised by: Sharon Corbett Financial Markets Policy Ministry of Business, Innovation and Employment 04 474 2900 21 February 2018

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Uncertainty about scope of insider trading prohibition

The insider trading provisions are contained in the Financial Markets Conduct Act 2013 (FMC Act). At a high-level, the insider trading provisions provide that if a person has access to information ahead of the rest of the market (which may be through their particular position or circumstance), they must not undertake trades in financial product markets (e.g. on a financial product exchange such as NZX) using that information.

Since the FMC Act was passed, there has been uncertainty about whether the insider trading provisions apply only to the secondary market (where financial products listed on an exchange are traded), or whether they also apply to the primary market (where financial products *to be* listed on an exchange are first issued/created).

The former insider trading provisions, which were contained in the Securities Markets Act 1988, applied only to the secondary market.

Given this uncertainty, a transitional regulation was put in place in 2014 before the FMC Act took effect, followed by a further temporary exemption in 2016, effectively providing that the insider trading provisions only applied to the secondary market (effectively preserving the then status quo) with some exceptions. The temporary exemption expired on 30 November 2017. Since then, the FMA has been applying an approach of not pursuing any instances of non-compliance that would previously have been exempt until the issue is formally addressed by the Government.

Applying insider trading provisions to primary market could constrain efficient market practices

There have been concerns that applying the insider trading provisions to the primary market could inhibit the ability of issuers to raise capital in some commonly accepted ways. For examples, issuers may undertake private share placements, particularly with large institutional investors (instead of offering shares to the public at large). These private placements rely on the exchange of information between the parties to ensure that investors are in an informed position to make a decision. The information exchanged can include material information about the issuer that has not yet been made public. If insider trading provisions did apply to private placements, there is a concern that parties may not participate because they are unable to access the level of information required to make an investment decision.

Given the uncertainty about the scope of the insider trading provisions and the problems raised about applying it to primary market transactions, it is important to identify the appropriate scope of the provisions and clarify the position as soon as possible.

2.2 Who is affected and how?

The issue affects issuers, investors and regulators in financial product markets

This issue affects:

- issuers of financial products that are listed on financial product markets;
- those that may consider investing in financial products in the primary market; and
- operators of financial product markets (e.g. NZX) and the financial markets regulator (the Financial Markets Authority).

The proposed solution should allow issuers and investors to continue to undertake legitimate capital raising activities, whilst maintaining integrity and confidence in financial markets in New Zealand. Issuers and investors support clarifying that the insider trading provisions do not apply to primary markets. NZX and the Financial Markets Authority (FMA) are also generally supportive of the proposed changes.

2.3 Are there any constraints on the scope for decision making?

No.

Section 3: Options identification

3.1 What options have been considered?

The options for addressing the problem are:

- Apply insider trading rules to the primary market: This option is not preferred as it would constrain certain efficient market practices as outlined under section 2.1
- Exempt all primary market transactions from the insider trading rules: This option is not preferred as there are some types of primary market transactions where the insider trading rules should apply in order to maintain confidence and integriy in financial product markets, as discussed further under section 3.2.
- Exempt some primary market transactions from the insider trading rules where it would constrain efficient market practices: preferred and discussed further below.

We considered whether insider trading rules should apply in various specific scenarios

We assessed a number of specific scenarios for capital raising in the primary market, in order to assess whether each should specifically be excluded from or subject to the insider trading provisions.

The specific scenarios were as follows:

- An initial public offering of shares (IPO)
- Private placements
- A further issues of listed financial products under clause 19 of schedule 1 of the FMC Act
- Listed unit trust where products are continuously offered
- Employee shares schemes
- Dividend reinvestment plans

A specific scenario that had already been considered earlier was:

- Acquiring derivatives by way of issue

We also sought feedback on whether the analysis differed for any other scenarios.

In each case, we assessed the extent to which:

- potential investors have equal access to material information e.g. due to statutory or contractual disclosure obligations;
- the interests of the company and existing shareholders are protected;
- application of the insider trading provisions may constrain efficient market practice; and
- confidence and integrity in the financial product market would be maintained notwithstanding any dis-application of the insider trading provisions.

3.2 Which of these options is the proposed approach?

The preferred option is that the insider trading provisions do not apply to the primary market with specific exceptions

The preferred option is to clarify that the insider trading provisions do not apply to the acquisition of financial products in the primary market by way of issue, except for acquisition of:

- derivatives (financial products often used to manage risk e.g. a product under which a New Zealand exporter agrees to sell US dollars on some future date at a rate agreed today); or
- newly issued units in listed unit trusts that are continuously offered.

This approach allows efficient market practices to continue.

Under this preferred option, a number of common market practices can continue, for example:

- Investors considering acquiring shares under a private placement can receive material information about the company that has not yet been made public and use the information to help decide whether to acquire shares to be issued under the placement.
- Companies issuing shares under an IPO or further issue of listed financial products can carry out a "bookbuild" where some select (usually large institutional) investors are given early access to information about the offer.
- Employee share schemes and dividend reinvestment plans can continue (although the potential for insider trading rules to apply to those scenarios is already very limited).

Potential investors will still have access to material information

Where new issues of shares are available to retail investors, the FMC regime will generally require issuers to disclose all material information e.g. through a Product Disclosure Statement or a notice confirming that continuous disclosure obligations have been complied with. All potential investors should therefore have access to the information needed to make an informed decision about whether to invest.

Where statutory disclosure obligations do not apply e.g. offers to wholesale investors only, those investors generally have sufficient bargaining power to contractually require that issuers disclose all material information.

The interests of the company and existing shareholders are still protected

There will be other mechanisms in place to ensure that for example, directors do not use inside information to issue shares to themselves or their associates on favourable terms.

The Companies Act 1993 will still require directors to resolve that the price and terms of any new issue of shares are fair and reasonable to the company and existing shareholders, and restrict directors from using company information for other purposes.

Maintaining integrity and confidence in financial markets in New Zealand

The factors above mean that even if the insider trading rules did not apply, there will be other limits on the ability of a person to trade using material information of the company.

There is a possibility that a person could acquire shares in a primary issue using material information about the company that is *unknown to the company itself* and therefore not otherwise disclosed to the market by the company. For example, during an issuer's IPO process, "A", an employee of a third party "B" could become aware that B will soon award a significant contract to the issuer, and A could purchase shares in the IPO on the basis of that information.

That scenario is likely to be rare. More importantly, the purpose of the insider trading rules is to protect integrity and confidence in financial product markets. Investors purchase listed financial products in the knowledge that they can subsequently trade them in a transparent secondary market where prices are set on the basis of demand and supply by those with equal access to information. In the secondary market, prices are distorted and confidence is eroded where some participants are trading on the basis of insider information.

In the example referred to, the transaction is not taking place on the market and the price or price range of the share has already been set by the issuer. A may be perceived as receiving an unfair

advantage in this scenario as A purchases shares with greater certainty about the investment. However, A's actions do not affect the prices paid by other investors or the operation of the financial product market.

In some such cases, other parties (such as B in the above scenario) may also have an action against A for breach of confidence.

Insider trading rules should still apply in relation to some specific scenarios

In relation to derivatives, a decision had already been made during the development of the FMC Act that due to the nature of trading in listed derivatives, acquisitions of derivatives by way of issue should be subject to the insider trading provisions. The nature of derivatives is such that the distinction between a primary issue and a secondary trade does not generally apply. Under the FMC Act, when a person enters into a derivative, it is 'issued' to them. When one person 'buys' a derivative on the secondary market, and another person 'sells' that derivative, legally both parties are "issued" derivatives. Therefore, to capture market transactions, the insider trading rules must capture acquisitions of listed derivatives by way of issue.

In relation to newly issued units in listed unit trusts that are continuously offered: the number of units in certain investment funds will expand or contract in order to balance demand and supply. When an investor buys units in the fund, based on the way these funds technically work, some of the units purchased may be newly issued units (and therefore primary market issues) and some may be traded units (traded in the secondary market). In practice, an investor will not know what type of unit they are buying. As there is no principled distinction between buying a traded or newly issued unit, both are treated the same under our preferred option.

The proposed approach is consistent with the long-standing position in New Zealand

The proposed approach is consistent with the long-standing position prior to the FMC Act.

The proposed approach also largely reflects the position under the temporary exemption arrangements that have been in place since this issue has been identified, except that:

- it is now proposed that newly issued units in listed unit trusts that are continuously offered will be subject to insider trading rules. It was identified during the course of analysing this issue that, as outlined above, there was no principled distinction between the primary market and secondary market in relation to these types of financial products.
- further issues of quoted financial products under clause 19 of schedule 1 of the FMC Act would be exempt from the insider trading rules (even though they have not previously been exempt). This is a new lower-cost capital raising option introduced under the FMC Act, where a company that offers newly issued financial products of the same class as products already listed (e.g. on NZX) may be exempt from usual disclosure requirements. However, the company must still be in compliance with ongoing disclosure obligations associated with being listed, and provide any other material information. In all cases, the company is required to have disclosed all material information to the public such that potential investors should have equal access to information needed to decide whether to invest, even without the insider trading rules. Applying the insider trading rules could constrain efficient market practices in relation to prior commitments to purchase from larger institutional investors.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (eg ongoing, one-off), evidence and assumption (eg compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	None	Not applicable
Regulators	None	Not applicable
Wider government	None	Not applicable
Other parties	In certain circumstances under the proposed exemption, some market participants may perceive some unfair advantage to certain parties (see the example referred to under question 3.2). But these circumstances are likely to be rare and any unfairness minor. There may also be other more appropriate causes of action (e.g. breach of confidentiality, breach of directors' duties).	Very low
Total Monetised Cost		Not applicable
Non-monetised costs		*Very low*
Expected benefits of proposed approach, compared to taking no action		

Regulated parties	Issuers and investors are able to continue participating in efficient forms of capital raising (such as private placements) with access to all relevant information. The benefit of the proposed approach applies generally for listed or to-be-listed companies that are seeking to raise capital. To give some sense of scale, we understand that in 2017 there were 30 instances of listed companies raising new share capital (e.g. through placements) totalling $3.1 billion and one IPO.[1] Some of these transactions may have been constrained if insider trading rules applied, though it is unknown how many. These numbers will also fluctuate greatly from year-to-year.	Medium
Regulators	None	Not applicable
Wider government	Parts of wider government are key institutional investors that are likely to invest under a private placement e.g. ACC or the NZ Super Fund. As with other investors, they benefit from being able to access all relevant information when investing under those processes.	Medium
Other parties	None	Not applicable
Total Monetised Benefit		
Non-monetised benefits		*Medium*

4.2 What other impacts is this approach likely to have?
Not applicable.

1 Chapman Tripp, New Zealand Equity Capital Markets: Trends and Insights, February 2018 http://www.chapmantripp.com/Publication%20PDFs/2018%20CT%20NZ%20Equity%20Capital%20Markets%20-%20Trends%20and%20Insights_6%20%282%29.pdf

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Stakeholders were generally supportive of the proposed solution

The proposal has been developed in consultation with the FMA.

MBIE carried out targeted consultation on a discussion document during August/September 2017. The discussion document was sent to the major law firms, ACC Investments (being parties that had contacted MBIE about the issue), as well as the Shareholders Association and NZX. MBIE has also discussed the issue with industry since 2014.

Six submissions were received on the discussion document from corporate law firms, the Auckland Crown prosecutor Meredith Connell, and ACC Investments.

The submissions generally supported the proposals for the reasons discussed above, with minor modifications which have been reflected in the final proposal.

Meredith Connell opposed the proposed exemption on the basis that:

- as a matter of legal interpretation, it was unclear that applying the insider trading rules would constrain market practices such as private placements; and
- where investors are aware of material information that is unknown to the company itself, the investor should not be able to use that information to acquire shares in the primary market.

On the first point, while we agree that the legal interpretation is not completely clear, there is at least a significant risk that the provisions would be interpreted to apply to private placements and other market practices. We therefore consider it important to clarify the application of the provisions. The second point is addressed under question 3.2 above.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?
The proposed approach will be implemented through a regulation change The new arrangements will be given effect to through an amendment to the Financial Markets Conduct Regulations 2014. The changes will clarify that the insider trading provisions do not apply to the acquisition of financial products in the primary market by way of issue, except for acquisition of: • derivatives; or • newly issued units in listed unit trusts that are continuously offered. The new arrangements effectively continue the status quo, but provide greater certainty. We will communicate the new arrangements to submitters and other interested parties. The regulations setting out the new arrangements will take effect on 30 March 2018.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
A monitoring and evaluation programme is in place to assess whether the outcomes of the FMC regime are being achieved. Monitoring data is being collected each year with an evaluation report to be produced in 2021, five years after the FMC regime first fully came into force. The data being collected includes questions relating to the level of confidence investors have in the regulation of financial markets. MBIE is also taking a 'living system' approach to the FMC regime. This involves an ongoing programme of working with the FMA to actively monitor and engage with stakeholders on the legislation, and responding to issues through amendment regulations or other means as necessary.

7.2 When and how will the new arrangements be reviewed?
There are no plans for a formal review of the proposed exemption regulations. However, MBIE will continue to actively engage with industry, NZX and the FMA. If concerns arise about harm to the market due to the exemption regulation, MBIE will consider whether changes are necessary.