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Share and share alike

By BRIAN GAYNOR

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Paul Swain, Labour's spokesperson on Commerce, is a politician with a mission. In a recently released white paper, he promised to inject some energy into the country's struggling stock exchange if Labour wins the general election. Swain has identified inadequate regulation as one of the main reasons why the sharemarket is in the doldrums. He also believes that ineffective legislation is discouraging individuals from investing in the productive sector.

The stock exchange is an easy target because it has been one of the world's worst performing sharemarkets in recent years. Since 1989, individual investors have preferred housing to equities as their bank housing loans have surged from $15 billion to $54 billion. In the same period, New Zealanders' holdings in locally listed companies have risen from $18 billion to just $21 billion.

Labour's proposed and long-overdue reform of our takeovers and insider trading regulations will meet entrenched opposition from powerful lobby groups.

Although its recent performance indicates that the sharemarket is badly in need of resuscitation, Swain's proposals will face intense opposition from the stock exchange and Business Roundtable. These two influential business groups have convinced previous governments that an unregulated market is the best option for New Zealand, even though the world's best performing sharemarkets, particularly in the United States, are highly regulated.

The most contentious issue raised by Swain is takeover regulation, particularly the situation where a bidder gains control of a listed company, but does not purchase 100 percent of the shares. In most other countries, when an investor acquires a threshold

shareholding- 20 percent in Australia- it has to make a full bid for the company. In some jurisdictions, there is the facility to make a partial offer, but the bidder must offer to purchase the same proportion of shares from all shareholders. There is no requirement to make a full bid or a proportional partial offer in this country.

The first major review of takeover law was undertaken by the Securities Commission in 1983. Members of the commission argued that the purchase of a controlling shareholding on the floor of the stock exchange was an inappropriate way to change the control of a company. The report said z "intervention in the free market by means of a takeover law may therefore be proposed on the grounds that there exists a form of 'market failure' . . . that can be remedied or reduced by the application of a set of rules".

Herein lies the crux of the argument. Supporters of New Zealand's lighthanded regulatory regime believe that larger players are the main generators of wealth and that they should be entitled to sell their shares first and at a higher price than other shareholders. They also believe that rules and regulations allow ineffective company executives to organise a defence against a takeover. Advocates of takeover legislation believe that all shareholders should be treated equally and in certain circumstances rules are necessary to protect and promote the integrity and efficiency of capital markets. The effectiveness of the sharemarket as a vehicle for productive investment - and the performance of the economy - will suffer if the integrity of the market is not maintained. The 1983 Securities Commission review recommended the introduction of takeover legislation. This advice was ignored.

The sharemarket shenanigans of the mid-1980s reflected little credit on the business community, particularly the stock exchange. Henry Bosch, chairman of Australia's National Companies and Securities Commission, wrote: "Those who were aware of the excesses practiced in New Zealand were not surprised that the crash of October 1987 hit that country hard - far harder than it hit Australia. The effects also lasted longer in New Zealand."

A 1989 inquiry into the sharemarket, chaired by the late Sir Spencer Russell, said that the poor performance of the market after the crash "represents not just difficult economic conditions but also a major loss of confidence by market participants in the rule-making structure, in the observance of ethical standards and in the general integrity of the sharemarket".

In 1988 the Securities Commission produced another massive report on takeover legislation. Once again it recommended a takeovers code and the equal treatment of all shareholders.

In 1991 the National government finally responded to calls for reform and a takeovers bill was introduced into Parliament. On September 28, 1993, the Takeovers Act received the royal assent and became law from July 1, 1994. But this was only half the process. The main objective of the 1993 act was to establish a

takeovers panel, which would formulate a takeovers code after public consultation. This code would then become law through a simple order-in-council, without having to go back to Parliament. It would be ad~ninistered by the panel.

In anticipation of the act, the Minister of Justice appointed an advisory committee in 1991 to formulate a code. The committee received submissions in support of takeover legislation from the stock exchange, the Securities Commission, the Institute of Directors, the Society of Accountants and other leading organizations. The only opposition came from the Business Roundtable and the Chamber of Commerce.

The Roundtable claimed that proposals "advanced [by the Securities Commission and others] are not justified by any economic theory or exemplary practical experience". The Chamber of Commerce wrote: "It is our opinion that provision should remain for premium rates to large blockholders, this being consistent with a free-market environment."

Following these submissions the committee produced a draft takeovers code. This was a compromise between the heavy-handed legislation proposed by the Securities Commission and the unregulated environment supported by the Business Roundtable.

A second round of submissions also supported the draft code although the stock exchange claimed that it was a more appropriate body to enforce the code than the takeovers panel. When this proposal was rejected, the exchange jumped sides and joined the Roundtable in vigorously opposing a code. Their lobbying was successful and, although the Takeovers Act 1993 is on the statute books, there is still no takeovers code.

The debate was reignited last year when Kirin Brewery of Japan purchased a controlling 45 percent interest in Lion Nathan. On Monday morning April 27, 1998, Lion announced to the stock exchange that Douglas Myers had sold 85.4 million shares (15.6 percent of the company) to Kirin at $5.40 per share. Kirin also announced that it would begin purchasing 24.4 percent of the company on the stock exchange at 12.3Qpm and would give small investors 24 hours to sell a further five percent. These offers were also at $5.40 per share.

Lion Nathan's directors jumped to the top of the queue and sold most of their shares and Kirin had a controlling 40 percent shareholding within seconds of its market bid opening. Many of Lion's shareholders were outraged with the process, particularly with directors who put their personal interests ahead of those of other shareholders. Overseas shareholders were also angry because many of them were in bed when the offer was announced and completed.

In a letter to Eion Edgar, chairman of the stock exchange, a New York-based broker wrote: "There has not been one positive statement made about the process whereby Kirin acquired their shares. The reactions vary from a

lack of understanding of our takeover code (given that it is so different from the rules that

"One suspects that, if a corporate Titanic sank in N' Zealand waters, the captain and officers would be on the first lifeboat. — AUSTRALIAN MEDIA COMMENT

apply here), through to disappointment that all shareholders were not treated equally, -through to outright indignation."

A large US institutional investor, David Herro of the Oakmark Funds, accused New Zealand of having "third world" corporate governance standards and the business editor of the *Australian Financial Review* wrote that "one suspects that, if a corporate *Titanic* sank in New Zealand waters, the captain and the officers would be on the first lifeboat to safety, all quite legally of course".

Although Swain's proposal to introduce a takeovers code will receive widespread support from investors, he will meet huge opposition from the stock exchange and Business Roundtable.

Last month Roger Kerr told an audience in Whangarei that the consensus view at a recent conference of business law professionals was that "the takeover] code should be buried for good".

The draft code, which was prepared by the advisory committee established in 1991, could be implemented with a simple order-in-council. If Labour wins the general election, and wishes to generate early legislative momentum, then a takeover code could be one of the new government's first major initiatives.

Another major issue Swain plans to address, if Labour wins the election, is insider trading, a serious criminal offence in most countries, because the use of undisclosed information to buy or sell shares for a profit undermines market confidence.

In the US the Securities and Exchange Commission has a sophisticated computer system that monitors suspected cases of insider trading. Breaches of the rules are vigorously prosecuted and a number of leading American businessmen, including Michael Milken, Ivan Boesky, Dennis Levine and Martin Siegel, have served jail terms for insider trading.

The insider trading statute in New Zealand - the Securities Amendment Act 1988 - is unique because it treats the issue as a civil, rather than a criminal, matter. The Securities Commission can investigate a transgression, but an insider trading case can only be brought by a listed company or aggrieved shareholder disadvantaged by a transaction. The penalty for a breach of the 1998 act is the return of the profit earned from the illegal trade.

In reality, listed companies will not take action against

their directors or employees and aggrieved shareholders do not have the expertise, information or financial resources to pursue a successful legal challenge. It is not surprising that no one has been successfully prosecuted for insider trading in New Zealand. This phenomenon is not a reflection of high ethical standards in the investment community.

Eric Watson's purchase of shares in McCollam Printers illustrates a major weakness in the insider trading legislation. At 5.05pm on May 16, 1997, Blue Star made a takeover offer for McCollam at $2.75 a share. Watson is chief executive of Blue Star. Before the announcement, activity in McCollam's shares had been unusually heavy - 464,400 shares were traded in just five hours. This compared with an average daily turnover of only/ 14,000 shares in the two preceding weeks. At 3.55pm, just 70 minutes before the bid, 398,000 McCollam shares went through the market at $2.36, the day's top price.

The Securities Commission undertook a review of McCollam's share trading activity under its general provision "to keep under review practices relating to securities, and to comment thereon to an appropriate body". The commission discovered that a company called Seahunter Investments had purchased a large number of McCollam's shares, including the 398,000, just 70 minutes before the bid. The commission was informed by the broker that Seahunter was a nominee company administered by Richard Johnston of Brown Woolley Graham, chartered accountants in Auckland. It was also informed (by Richard Johnston) that the shares had been acquired "at the instructions of, and on behalf of, private interests of Mr Eric Watson".

Watson strongly disagrees with many of the commission's conclusions, but he agreed to make a payment, on a no fault basis, to shareholders who sold McCollam shares just prior to the offer.

In most other countries, Watson would be under investigation by an enforcement authority, but the New Zealand Securities Commission concluded that he had not breached the 1988 act. In New Zealand you can only be accused of insider trading if you receive inside information from a listed company. As Watson knew about the McCollam acquisition in his capacity as chief executive of Blue Star, which is not listed on the stock exchange, his purchase of McCollam shares was exempt from the-insider trading regulations.

The McCollam insider trading investigation is a clear example of the inadequacy of our securities regulations. The past two governments have pledged legislative reform, particularly a takeover code, but neither has fulfilled its promises.

The sharemarket should play a vital role in allocating resources in a free market economy. The ailing New Zealand stock exchange is not fulfilling this objective. adequate regulation of the sharemarket is not the only explanation for its poor performance, but it is a contributing factor. A lack of confidence in the stock exchange and its market surveillance panel is one of the reasons why individuals generally prefer residential housing over productive equity investment.

Any attempt by Swain, and other politicians, to restore confidence in the sharemarket would have positive implications for the New Zealand economy. Unfortunately, these moves will have to be government-initiated, because the stock exchange -is moribund and seems to be incapable of acting in the best interests of all participants.