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Reform of Securities Trading Law – Evolution & Risks

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Introduction*

This paper considers the risks and possible evolution of the approach to regulation that is reflected in the three volume discussion documents *Reform of Securities Trading Law* that were published by the Ministry of Economic Development (MED) in May 2002. These volumes focus respectively on a review of insider trading, proposed new market manipulation law, and the issues of penalties, remedies and the applications of securities trading law.

Much legislation has been put in place since the publication of these documents. The Securities Market and Institutions Bill (Bill) was enacted on 26 November 2002. It resulted in the Securities Amendment Act 2002, the Securities Markets Amendment Act 2002 and the Takeovers Amendment Act 2002. These all came into force on 1 December 2002. The first increases the Securities Commission's (SC) powers. The second gives the SC four main areas of new responsibility. It provides for: continuous disclosure of information by listed public issuers; registration and supervision of securities exchanges; SC-initiated court action seeking civil penalties for insider trading; and disclosure by directors and senior offices of public issuers of any trading by them in securities of these issuers or related issuers. The third act amends the Takeovers Act 2002.[1] Occupational licensing for investment advisers is also in the wind.[2]

In considering the likely evolution and risks of this approach, the paper takes all these existing and contemplated regulations as implemented givens. The question then is the degree to which they will achieve their stated purposes.[3] No system is perfect, and the proposed approach will inevitably have some unintended and undesired consequences. These arise from the problems of incentives and information that accompany all goal-imposing regulations.[4] The evolution of the system will therefore depend to some degree on what problems emerge and how the authorities will respond to them. This depends in part on their incentives and constraints. Here the incentives of the key regulator, the SC, may be particularly important.

The topic is too large to do justice to in a single paper. The following sections (see the contents page for a listing) aim to bring out some of the problematic aspects of the proposed approach that will affect its evolution. The final section presents some tentative conclusions.

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* The author expresses his thanks to the large number of his financial sector colleagues who have assisted him in the preparation of this paper. He particularly thanks Roger Kerr for his encouragement and many suggestions, David Goddard and Kirstie Hewlitt for their papers and their patient responses, and Liam Mason for a very constructive dialogue. However, the author alone is responsible for all errors and all the views expressed.

1 For a summary, see www.sec-com.govt.nz.

2 'Government to move on financial advisers', *The Independent*, 18 December 2002. (Note however that contrary to the heading, the minister of commerce makes it clear in the article that no decision has been made. Nor is it in a hurry to do so.)

3 This makes the benchmark the *status quo*. For public policy purposes a comparative institutional framework would be required, based on well-identified achievable alternatives. The section below on the path not taken outlines one alternative.

4 The removal of a common law freedom to contract differently (eg to vote to opt out) is one manifestation of goal-oriented (rather than process oriented) legislation.

What do the government and the Securities Commission aim to achieve?

All the discussion documents state that one of the government's key objectives is "promoting confidence in the New Zealand sharemarket". The aim is to increase certainty about the integrity of the market and in the mechanisms for implementing the law. The overall goal is said to be to "minimise market abuse in New Zealand and improve confidence in our market for both New Zealand and international investors".

The documents also state that the measures in the Bill are designed to promote confidence by "increasing the effectiveness and efficiency of the law and regulatory institutions governing securities markets, and the comparability of New Zealand law with the law of other jurisdictions".

The SC states that its purpose is to strengthen confidence in New Zealand's capital markets by promoting their efficiency, integrity and cost-effective regulation. This acknowledges that the cost of regulation is a consideration.

Policy rationale

Why is "promoting" or "improving" confidence a good thing"? A likely rationale for the current approach is that:

- confidence is too low because market abuse is too high;
- confidence is also low because of 'gaps' in New Zealand's regulations compared to overseas 'best practice' – perceptions matter;
- high market abuse results from low investor protection;
- low investor protection means low investor interest;
- low investor interest results in less deep and liquid markets;
- less investor interest and less liquid markets raises the cost of capital for reputable issuers;
- a higher cost of capital for reputable issuers means less economic growth;
- in any case it is unacceptable and inconsistent with the rule of law that "market abuse is tolerated"; and
- private remedies will not work, otherwise the problem would not exist.

On this basis, it follows that more prescriptive, well-enforced regulation will improve market access, depth and liquidity, participation and investment by improving both the reality and the perception that investors are protected.

This approach also postulates that confidence can be built up by greater forced disclosure. One notion here is that, just as sunlight is a good disinfectant, disclosure will show up roguery and render it harmless.[5] Another notion is that forced disclosure will reduce opportunities to profit improperly:

> If public issuers publicly disclose price sensitive information in a timely manner it reduces opportunities for those 'in the know' to obtain a benefit from the use of the undisclosed information. Further, continuous disclosure by public issuers can encourage

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[5] See Gordon Walker and Brent Fisse (ed), *Securities Regulation in Australia and New Zealand*, Oxford University Press, 1994. The notion of showing up roguery and thereby making it harmless is attributed to W. E. Gladstone prior to 1844 (see p 60).

> investors to have integrity in the market by helping to counter the creation of false markets, and the distortion of markets through false or misleading rumours.[6]

To what degree do the facts support the above propositions? Are there alternative explanations that better fit the facts and would lead to different conclusions? How much confidence would be too much and at what point, if any, would regulation become excessive? Before considering some aspects of these questions, a brief historical perspective on such debates might be useful.

Brief historical perspective

In a comprehensive history of the New Zealand Stock Exchange, David Grant has traced its antecedents back to the formation of the first joint stock company in London the middle of the 16th century and the development of a highly organised stockmarket in London by the 1690s.[7] He observes that unlicensed brokers brought the rest into dispute and that brokers become the scapegoats when the economy was in trouble.

In Grant's view, by 1695 the "two factors crucial to any Stock Exchange" were in place. These comprised strong and abiding notions of mutual trust between broker and client, as well as between brokers; and independence from outside interference, particularly from state interference. Grant states that:

> This wish to control their own affairs permeated the culture of Stock Exchanges for the next two centuries, and was a preoccupation of New Zealand brokers from the beginning. Indeed, it acquired a kind of sanctity. In order to achieve it, brokers strove to win a reputation for trustworthiness and honesty, with the dictum 'my word is my bond' emerging as the very cornerstone of economic survival. … In New Zealand, stockbrokers vigorously upheld this hallowed tradition … .[8]

The notion of a role for the state in 'protecting investors' by forced disclosure (in the primary issues market) is relatively recent. In a brief history of securities regulation in New Zealand, Jonathan Lindroos and Gordon Walker New Zealand trace the concept that government-mandated disclosure might assist investors back to a Gladstone Committee Report that led to the Joint Stock Companies Act 1844 (UK).[9] This Act required companies to file with the Registrar a return "detailing the names and occupations of promotors [sic] and officers, and the purpose of the company, together with *any* prospectus and advertising" [emphasis added].[10]

They state that these minimal requirements were deemed too onerous and were 'swept' away by the Joint Stock Companies Act 1856 (UK) that formed the basis of the Joint Stock Companies Act 1860 (NZ). However, the Companies Act 1882 (NZ) copied the Companies Act 1867 (UK) in requiring companies to disclose details of *contracts* made prior to flotation.

Lindroos and Walker trace the current legislative expression of the notion that the solution to fraudulent company activities lay in forced disclosure to the Companies Act 1901 (NZ). This Act was based on the Companies Act 1900 (UK) that itself

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6 Discussion document, volume 1, p 11.

7 David Grant, Bulls, Bears & Elephants,: A History of the New Zealand Stock Exchange, Victoria University Press, 1997.

8 Grant, *op cit*, pp 16-17.

9 Jonathan Lindroos and Gordon Walker, 'A Short History of Securities Regulation in NZ', chapter 4, in Walker and Fisse, *op cit*.

10 Lindroos and Walker, *op cit*, p 61.

resulted from a Davey Committee report. This Act was the origin of current prospectus requirements.

The Davey Committee report recognised the tension between legislating for 'investor protection' and the need to avoid unduly impeding the flow of commerce and therefore to "[protect] the process of forming companies, 'which have bought so much business to England'".[11]

Lindroos and Walker note that the Report of the Ministerial Group on Securities Law Reform (the Roche report) in 1991 identified a [rather different] tension:

> … regulation cannot and should not attempt to relieve investors. Regulation cannot remove the possibility of losses. It should not be the purpose of legislation to improve the outcomes for investors generally by 'second guessing' the market; regulation may over time, inhibit desirable innovation which may reduce the choices available and thereby harm investors.[12]

The goalposts representing the balance between investor protection and the need to avoid unduly impeding capital raising have moved radically in the last hundred years, but clearly there is a strong view that they have not been moved nearly far enough. Are things really that bad?

Are confidence, access and liquidity really a problem?

The confidence issue - perception

Confidence is not necessarily a good thing. It needs to be soundly based. There may be problems of over- or under-confidence. Presumably, the more foolish or greedy are investors, the less we would want them to be confident.

Over-confidence can occur when government statements or actions are interpreted as underwriting particular investment decisions. This perception undermines *caveat emptor* – the 'buyer-beware' principle that would require investors to take responsibility for their own decisions. When *caveat emptor* is undermined, people are likely to become too careless about the risks, as the Roche report warned. For example, the current leaky buildings syndrome suggests that home buyers had too much confidence that local government certification meant that homes would not leak. Experts generally agree that the losses by the savings and loans organisations in the United States arose from the *moral hazard* problems induced by the federal deposit insurance arrangements at that time. Over-confidence in investing in shares will lead to pressures on governments to 'do something' whenever there is a sharemarket crash.

In New Zealand today, the public could be forgiven for lacking confidence in the integrity of New Zealand's capital markets given the repeated, sweeping attacks on business enterprise, the stock exchange and the sharemarket since the October 1987 sharemarket crash.

In May 1988, the prime minister told an international audience in Los Angeles that the New Zealand sharemarket had gained a reputation as the "haunt of the last of the cowboys of the sharemarket world" and that "creative accounting" had not enhanced New Zealand's international image.[13] In fact, the big sharemarket losses arose not

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[11] Lindroos and Walker, *op cit*, pp 60 and 67.

[12] Lindroos and Walker, *op cit*, p 77.

[13] Grant, *op cit*, p 327.

from fraud or creative accounting but from investment and property companies that were highly geared when asset values fell. Sir Geoffrey Palmer used similar sweeping allegations in public to get the Securities Amendment Act 1988 passed.

On coming to power in 1999, the government labelled New Zealand's capital markets a "wild west", asserting that a lack of confidence blocked access to capital and stunted economic growth.[14] There was a barrage of such calls from editorial writers and senior politicians, including the prime minister and the commerce minister, late in 2000 and early in 2001 when Lion Nathan was bidding for Montana.[15]

The "wild west" assertion has been repeated so many times in the popular press that in 2001 a senior journalist said that it was time to confess that it had become a 'mantra' and 'move on'.[16] Her call is likely to be lost in the babble. There is a widespread assumption in New Zealand that the common law protections against fraud do not exist and that the alternative to state regulation is a state of lawlessness:

> Just as the American wild west was lawless, so largely is the world of financial advisers in New Zealand.[17]

It would be surprising if the endless recitation of this mantra by senior politicians and journalists has had no affect on public opinion. Brian Gaynor noted that a 1992 public opinion survey found that 44 percent of respondents believed the sharemarket was manipulated, compared to 16 percent who thought it was not. Only three percent thought all shareholders were treated fairly; 77 percent thought big investors can manipulate the market.[18]

The question to be asked is how well informed these opinions were. In respect of the last point, obviously large orders can move prices in relatively illiquid stocks. However, it is another thing to say that a person capable of making a large order can manipulate a market at will. The risk they face is that others with deeper pockets will be moving in the opposite direction, or that the general climate of opinion will be changing against them. The 'thin-market' situation is not perfect, but there is no magic wand. Illiquid securities will always exist, and prices will always be volatile as a result. This volatility may fuel prejudices about manipulation and insider trading.

Only weak voices have been raised in official circles in defence of the integrity of New Zealand laws and the sharemarket during this period. This is partly because the SC has been an advocate of greater regulation.[19] Clearly there is a potential conflict between this goal and the responsibility to defend the reputation of the New Zealand's markets.[20]

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14 Simon McArley, 'Another dose of securities law to bolster investor confidence', *The Independent*, 4 December 2002.

15 See, for example, 'Not so Wild West', *New Zealand Herald*, 13 October 2002; 'Swain to call in the sheriff', *The Dominion*, 13 February 2001; and 'Leaving an acid taste', *The Press*, 13 February 2001.

16 Fran O'Sullivan, 'Market rises from the dead', *New Zealand Herald*, 5 March 2001.

17 Rob Stock, 'Beware the financial cowboys. In the wild lawless frontier of financial planning, choosing an adviser to trust can be a risky business', *Sunday Star-Times*, 23 March 2003.

18 Brian Gaynor, 'NZSE and the Securities Market in New Zealand', Walker and Fisse, *op cit*, p 123.

19 Peter Fitzsimons, 'The Review of the New Zealand Securities Commission: The Rise and Fall of a Law Reform Body', mimeograph.

20 The SC's early response in 2002 to unwarranted attacks from Australia on the integrity of the accounts of Telecom Corporation of New Zealand arguably damaged that company's reputation, notwithstanding its subsequence clearance of TCNZ.

For the record, one diffident defender in official circles was the Law Commission. In 1989, it commented that:

> Some of the more extreme criticisms are misconceived or exaggerated. Our laws are not as lax as some would suggest, although their impact is not easily understood because they are only in part statutory. Although out of date, they cover very much the same ground as their counterparts in the United Kingdom, Australia and Canada.[21]

However, in terms of informing general public opinion, it is the sweeping denunciations that command the headlines.

The confidence issue - evidence

New Zealanders' fortunate heritage of sound English institutions has always been conducive to attracting overseas investment. The country has benefited from overseas investment on a large scale from the time it was a colony and London was regarded as a 'home' city. It still benefits from large net inflows. There is no evidence that New Zealand's markets under pre-1989 laws would be unattractive to investors, if the economic climate were favourable.

> Offshore investors adored us in the late 1980s and early 1990s, lured by the hypnotic call of an economic free market nirvana being constructed by first Roger Douglas and then Ruth Richardson. This saw foreigners – both companies and institutional investors – at one stage owning up to 60% of our market … But basically a foreign exodus started when Jim Bolger took a tea break and Labour a step to the left.
>
> It is not just overseas corporate owners who have been leaving. Offshore institutional investors have … been "decreasing their exposure" to the increasingly left-leaning New Zealand economy for a number of years.[22]

It is sometimes argued that the proportion of local shares owned locally is low and that this is a sign of lack of investor confidence in the New Zealand sharemarket. What are the facts?

- The proportion of the New Zealand sharemarket (mid-March 2003) owned by New Zealand fund managers and retail investors is estimated to have risen from 30 percent a decade or so ago to 35 percent.[23]

Is this unduly low? What evidence would support such a view? Other things being equal, we should expect New Zealanders to show less 'home market bias' than residents in countries with larger and more diversified sharemarkets, or with less open capital markets.

In any case, the argument is weak in that it suggests that the opposite side of the same coin – a high proportion of overseas ownership – implies a high level of confidence internationally in the local market.

Statistics on absolute share ownership may provide a more useful comparison.

- The NZSE reports that 44 percent of New Zealanders have some form of direct or indirect investment in shares. The most popular are NZSE listed shares (21 percent) and managed superannuation funds with share investments (16 percent).

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21 New Zealand Law Commission, *Company Law Reform and Restatement*, June 1989.

22 Roger Armstrong, 'Nobody Loves Us, Everybody Hates Us', *UnlimitedNet*, 1 November 2002.

23 Armstrong, *op cit*.

- An international study by the Australian Stock Exchange found that New Zealanders' direct share ownership was 30 percent – a level similar to that of the US and the United Kingdom, but well below the 41 percent level in Australia.[24]

There is no evidence here of any New Zealand-specific aversion to share ownership.

Another test of the level of confidence in the integrity of the New Zealand sharemarket is the price earnings multiple. Putting the probability of a takeover bid aside, the less confidence investors have in the competence or integrity of a company's management, the lower the firm's share price should be as a multiple of current earnings.

- New Zealand's sharemarket is currently pricing earnings more highly in relation to overseas markets than the long-run average relationship.
- In a historical, (time series) comparison, the price-earnings multiple is marginally below a long-run average.[25]

These relationships seem reasonable, given other factors such as the higher exchange rate, the uncertainties over Iraq, and the international slowdown.

None of this is to argue that share prices would not be higher if existing laws were better enforced. But there is little here to suggest that the sharemarket-wide effect would be discernible. Price-earnings multiples are too volatile to be attributable to fluctuations in the enforceability of the law. The major driver must be changes in views about the economic outlook, particularly in respect of future company earnings.

Systematic cross-country research by the World Bank and others finds that New Zealand ranks very highly indeed for the quality of its laws, including the protection it provides for investors. This is largely because of its base in common law and its reliance on an independent, incorruptible judiciary.

- "Common law countries have the strongest protection of outside investors – both shareholders and creditors – whereas French civil law countries have the weakest protection. German civil law and Scandanavian countries fall in between."[26]
- Common law countries tend to have particularly strong accounting systems, strong protection of outside investors, and large equity markets. The adaptability and flexibility of a legal system is also important for economic development, and this is also a relatively strong feature of the common law countries.[27]
- New Zealand is perceived to be the third least corrupt country in the world in Transparency International's 2001 index, behind Finland and Denmark. Australia is 11th, the United Kingdom 13th and the United States 16=.

[24] New Zealand Stock Exchange Share Ownership Survey, 2000, executive summary.

[25] Personal communication, First NZ Capital research.

[26] Thorsten Beck, Alsi Demirguuc-Kûnt and Ross Levine, 'Law and Finance: Why Does Legal Origin Matter?', World Bank Policy Research Working Paper 2904, October 2002.

[27] Thorsten Beck, Alsi Demirguuc-Kûnt and Ross Levine, 'Law, Politics and Finance', World Bank: NBER, Working Paper series, April 2001.

- New Zealand is ranked in the top category for investor protection (along with 13 other countries out of 44.)[28]

- New Zealand is ranked sixth out of 40 countries for the security of its legal system and protection of creditors and shareholders, according to one study.[29] (It is ahead of Australia, but behind Japan, the United States, the United Kingdom, Hong Kong and Canada.)

- New Zealand is ranked in the first category for its legal system (in a group of 13 out of 50 countries) and also for its protection of private property (in a group of 22 countries) in another study.[30]

Such statistics amply support the Law Commission's point cited above. The (inevitable) clamour for more regulation in the US following the end of the long bull market in that country simply serves to emphasis the gross irresponsibility of the 'last frontier of the Wild West' mantra about New Zealand's markets.

Investors at large, the New Zealand public, officials and politicians are probably largely unaware of New Zealand's meritorious rankings. This seems both regrettable and unfortunate.

The decade-long attacks in the media on the stock exchange are not an isolated phenomenon. Other long-standing institutions are also at risk.[31]

Access and liquidity

Efficient capital markets minimise the cost of capital by allowing funds to be channelled from investors to businesses at least cost. Large listed companies need further equity capital from time to time. Small and medium-sized companies that need outside equity look for an efficient IPO market.

- New Zealand has a respectable ranking for market access. In 2002 it was ranked 8= out of 82 countries by the Milken Institute's Global Capital Access Index.

This index measures the breadth, depth and vitality of capital markets and their openness. Australia came 10th.

Efficient capital markets are not necessarily deep or liquid, although both are desirable attributes considered in isolation. There is evidence that the liquidity of the secondary market in a security markedly affects the cost of capital.[32] The low-cost focus of the New Zealand Stock Exchange has helped liquidity by reducing the costs of buying and selling shares in the secondary market.

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28 Sergei Sarkissian and Michael J. Schill, 'The Overseas Listing Decision: New Evidence of Proximity Preference', SSRN Working Paper series, June 2001.

29 Charles Himmelberg, R. Glen Hubbard, and Inessa Love, 'Investor Protection, Ownership and Investment', World Bank Working Paper 2834, June 2002. New Zealand was 1= for legal efficiency and 9= for both creditor and shareholder rights.

30 Stijn Claessons and Luc Laeven, 'Financial Development, Property Rights and Growth', World Bank Working Paper 2924, January 2002.

31 Other institutions under threat include the right to appeal to the Privy Council, the monarchy (the republicanism debate), the Westminster system (MMP, the convention that a minister will defend the public service rather than attack it), and the common law.

32 Yakove Amihud and Haim Mendelson, 'The Liquidity Route to a Lower Cost of Capital', *Journal of Applied Corporate Finance*, Volume 12, No 4, Winter 2000, p 8-25, particularly figure 4.

- On one measure (based on basis point buy-sell spreads) New Zealand's sharemarket is the 15th most liquid of 43 countries. This is marginally ahead of Australia's 18th slot.[33]
- On another measure – turnover velocity – New Zealand ranks a respectable 19th out of 45 exchanges, but it is much higher in Australia.
- A study for the New Zealand Business Roundtable by Dr Martin Lally found no cost of capital advantage for New Zealand in harmonising currency regimes with Australia, but a significant potential cost of capital advantage in adopting the United States dollar.[34]

Overall, New Zealand seems to compare very favourably internationally given the small size of its markets.

Enforcement

There is widespread concern, dating back to before the 1987 (global) sharemarket crash, that fraud and self-dealing in the New Zealand corporate securities markets are not dealt with by the legal system as promptly and as effectively as they should be. The author has not found a thorough analysis to date of the problem.

MP Stephen Franks was recently reported as saying that the NZSE's market surveillance panel had plenty of effective remedies for breaches of its listing rules. These include suing for damages or taking action for breach of contract. He had served on the panel and also on the SC. In his experience, the problem arose from lack of will, not lack of means.[35] I suspect that this view is widely shared.

I understand that the SC is putting greater emphasis on enforcement where its powers permit. (In fairness it should be noted here that the SC has not had the power to bring criminal proceedings. There are criminal penalties for breaching securities law. It is the Registrar of Companies who is responsible for prosecutions under securities law, through the National Enforcement Unit. The decision to prosecute here has been out of the SC's hands.)

A business colleague who has been party to legal actions in relation to self-dealing also sees the key issue as the failure of the authorities to act. In his view the government should take the lead (given the costs of litigation) in prosecuting some significant breaches in order to 'set the standard'. This would be a 'public good' activity. It should then leave it to the private sector (owners and agents) to take further cases.

Unacceptable delays between the filing of a case and a final decision are part of the problem. In his most drawn out self-dealing case, my colleague took nine years to get a decision out of the courts. The key cause of the delay was obstruction in relation to disclosure.

Problems of unacceptable delays cry out for a legal analysis of court processes, the awarding of costs and other matters. A good analysis would discuss how and why these delays have changed through time and how they differ across jurisdictions.

[33] Sarkissian and Schill, *op cit*, table 4.

[34] Martin Lally, The Real Cost of Capital in New Zealand: Is It too High?, New Zealand Business Roundtable, 2000.

[35] Nick Stride, 'Lawyers take aim at NZSE rules revamp', *National Business Review*,

The difficulties of taking a private prosecution are real, but can be exaggerated. A recent successful insider trading action was taken by Catherine Franks and Roger Kerr against the former chairman of Fletcher Challenge. They did not find the SC helpful in the pursuit of this case because of its concern to protect its information sources. Franks and Kerr had to obtain a court decision to achieve disclosure. The case was eventually settled out of court for a high sum. They have contributed further to solving the 'public good' problem by setting up a trust to fund future actions.

Nonetheless, the enforcement of insider trading actions is a problem worldwide because of the fundamental difficulties with this relatively novel and ambitious legislation. There are ample grounds for disquiet about current and proposed arrangements.

Summing up

All the loose talk of cowboys and the wild west is grossly irresponsible in the light of New Zealand's high rankings for investor protection and the quality of its laws and legal system. It also ranks very highly for market access and respectably for liquidity. Nor is there any credible evidence of a confidence problem in the statistics on domestic sharemarket ownership or price-earnings multiples.

Other material suggests that public opinion could be woefully informed about the relatively high ranking of the New Zealand market internationally.

There is evidence of a decline in United States and London institutional investor interest, but this appears to be more related to the anti-growth policies of successive governments than to the absence of state regulation.[36]

There does appear to be an enforcement problem in relation to the stock exchange's listing rules and the common law in relation to self-dealing. If so, the policy goal might be better stated as being to promote the "better enforcement of existing laws against self-dealing" rather than "promoting confidence". However, the current and proposed measures do not appear to be targeted at this problem. Of course, enforcement problems have been exacerbated by the addition of new offences, notably in relation to insider trading, that are notoriously difficult to enforce.

In conclusion, the material in this section appears to support the view of the 1991 Ministerial Working Group that the better enforcement of long-established securities law was more important than the development of new law and state regulation. How to best achieve this appears to be an open question.

International harmonisation vs regulatory competition

The points being advocated

> … there is an international focus on corporate governance and financial reporting and the importance of convergence to internationally recognised standards. It is critical that New Zealand be seen to be a world player in these respects if we are to attract incoming capital flows and maintain our standing as a developed capital market.[37]

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36 Armstrong, *op cit*.

37 Jane Diplock, 'Clarity begins at home', 15 November 2002.

> Despite the need to consider local conditions there are compelling arguments particularly for a small economy to conform its regulation to best international standards and to the standards of its major economic partners.[38]

The recently increased openness of securities markets globally and the increased degree to which companies list in more than one jurisdiction undoubtedly raise jurisdictional issues. Back in the nineteenth century when the English common law countries were open and globalised, the system of common law facilitated international exchanges by transcending national boundaries.

The discussion documents suggest that confidence can be promoted *inter alia* by increasing "the comparability" of New Zealand securities law "with the law of other jurisdictions". The discussion documents also state that the MED has given particular attention to comparability with Australian law in view of the 2001 Memorandum of Understanding on Business Law Coordination between New Zealand and Australia.[39]

The deeper basis for taking these positions is not clear. However, the MED has stated elsewhere, in explaining its supportive advice to the government on takeovers that:

> We do believe, however, that the introduction of a takeovers code may contribute to the Government's key objective of increasing investor confidence in the New Zealand market. Although a greater part of the evidence relating to investor perception and confidence in the market is anecdotal, and it is difficult to provide enough authoritative research on perceptions to argue one view over another, we believe the comparability and familiarity of a country's regulatory regime is seen by international investors as an important factor in encouraging investment.[40]

Such comments create an unfortunate impression that MED has a low burden of proof in relation to regulation for 'confidence' and may not give much attention to adverse effects for really important goals (eg efficient corporate control).

An extensive paper on the issue of cross-country law coordination by David Goddard, a special counsel to the Ministry, has argued reasonably that:

> The question of whether broader or deeper coordination is desirable cannot be answered in the abstract. It needs to be addressed in relation to a particular sphere of business law and the answer will depend to a significant degree on whether the appropriate model for coordination in that sphere can be identified and implemented in practice.[41]

Coordination is not the same thing as harmonisation. In this paper Goddard does not advocate harmonisation as a general solution. However, in addition to the above citation from the discussion documents, several factors suggest that some officials in New Zealand may see a significant degree of harmonisation as the default option:

- The SC has endorsed the International Organization of Securities Commissions' (IOSCO) detailed prescriptions for securities market regulations that are to be applied in principle across all jurisdictions;
- As cited above, the SC sees 'compelling arguments' for New Zealand to conform to such standards;

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[38] Jane Diplock, 'Developments in New Zealand's Secondary Market Structure and Regulation: New Zealand's Approach to Global Regulatory Advances', 9-10 April 2002.

[39] See, for example, p 9 in the MED's Discussion Document, volume III, *op cit*.

[40] Letter from the then deputy secretary of MED to Roger Kerr, 7 July 2000.

[41] David Goddard, 'Business Laws and Regulatory Institutions: Mechanisms for CER Coordination'.

- The SC and others also cite approvingly from a paper by professor Bernard Black of Stanford University[42] that provides a detailed checklist of prescriptive securities market regulation for all countries, whether they are common law countries or not; and
- Professor Black's paper also makes an argument that regulatory competition in respect of mandatory disclosure rules will be bad because it will tempt regulators to "compete by pandering to the [company] managers' preference for laxer disclosure of manager compensation and self-dealing". The SC interprets Black's research as suggesting "that continuous disclosure and insider trading legislation need particular attention in a market".[43]

An informal paper by MED's Kirstie Drake and David Goddard (that explicitly does not represent the views of MED) puts considerable weight on the use of Australian law as a "useful benchmark" in considering New Zealand law.[44] Their paper has caused the writer of this paper, at least, some confusion as to how to interpret it. Given their central position and the considerable circulation their paper has had, it may be useful to explain why. Consider the following (widely separated) arguments in their paper.

> Securities laws have a significant mandatory core … We will never be able to establish mutual recognition laws with Australia in relation to securities regulation if our substantive laws are seen as much less stringent, or our institutions as much less effective … the potential scope for regulatory competition should not be ignored, but its significance should not be exaggerated. We can compete on the dimensions of quality and efficiency of procedures and institutions, and (at last in some contexts) the detail of our legal regimes. But the core substantive requirements, will rarely, if ever, be a relevant dimension of competition.
>
> Of course, if all that proponents of regulatory competition are saying is that we should adopt regulatory regimes which deliver the best possible outcomes for New Zealand, they are right – but this does not tell us why having laws which differ from the laws of Australia is likely to contribute to this goal. The positive case for being different must go further, and assert that we can deliver higher quality, lower cost regulatory regimes that will encourage businesses to adopt the New Zealand regime rather than the Australian one.[45]

At one reading, this seems to be arguing that New Zealand's securities laws should be the same as those in Australia unless there is a 'positive case for being different'. This appears to put the burden of proof on those who think it would be inefficient to harmonise with Australia. However, I understand from its authors that they are arguing that New Zealand should adopt the best possibly regulatory regime for New Zealand, regardless of whether it differs from the Australian one or not. What they are opposing is being different for the sake of creating a 'positive' competitive difference. It is not clear who is arguing the contrary case. I also understand them to be saying that if New Zealand were to adopt a new law, as a prior decision, overseas precedents would be looked at, and particular attention would be paid to Australian law.

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42 Bernard S Black, 'The Legal and Institutional Preconditions for Strong Securities Markets', *UCLA Law Review*, Vol 48, pp 781-858, 2001

43 Jane Diplock (April 2002), *op cit*.

44 Kirstie Drake (MED senior analyst) and David Goddard (special counsel), 'Securities laws – key themes and recent developments', mimeograph..

45 Drake and Goddard, *op cit*, section 5, pp 8 and 6 respectively.

I also understand that MED's focus is on getting the most *effective* arrangements for New Zealand capital markets, regardless of whether this requires narrowing or widening differences with Australian law or the IOSCO's prescriptions. I am not clear why MED's focus is not on getting the most *efficient* arrangements. The most efficient arrangements would channel funds, *inter alia*, from investors to issuers at the least real resource cost for the preferred product range.

A reality check?

One question to ask anyone who pushes the concept of a highly intrusive 'international standard', like the IOSCO guidelines, as the 'default' option for New Zealand, is how countries like the United Kingdom, United States, Canada, Australia and New Zealand got to be amongst the wealthiest countries in the world in the first half of the last century – without the 'benefit' of the intrusive laws of the last half century relating to mandatory disclosure, takeovers, insider trading or 'market manipulation'. All enjoyed the benefits of the United Kingdom system of common law.

Another question to ask is how satisfied the countries most in line with the IOSCO guidelines are with the level of integrity of their markets. The regulatory disarray in the United States, post-Enron speaks for itself. What about Australia? At least one Australian does not think that what it has is adequate.

> We've got a market here where insider trading, stock manipulation and abuses of disclosure are rife.[46]

Jeffrey Lawrence, citing American jurist Frank Easterbrook in support, postulates that:

> In countries with liquid capital markets where corporate managers are subject to the discipline of the market for corporate control (i.e. hostile takeovers) and the capital markets (i.e. credit rating agencies and bond investors), there is no need for onerous corporate regulations.[47]

The economic literature on harmonisation

Economist Neil Quigley recently examined the arguments for and against harmonisation and regulatory competition in detail.[48] He discounted the common argument that regulatory competition will lead to a 'race to the bottom' for regulatory standards by noting that it only had force if the home jurisdiction (eg the New Zealand sharemarket) would not bear all or most of the costs of the adoption of low standards. It seems more likely that investors would abandon it in droves. Few, if any, are forced to invest in the New Zealand sharemarket.

The burden of proof

A second question relates to the burden of proof. The presumption under the English common law is that the preservation of common law individual liberties comes first.[49]

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46 Michael West, 'Margin Call: Blame the Institutions', *The Australian*, 5 June 2001.

47 Jeffrey Lawrence, 'The Economics of Market Confidence: (Ac)Costing Securities Market Regulations', Centre for Corporate Law & Securities Regulation, University of Melbourne. It can be downloaded from http://cclsr.law.unimelb.edu.au/research-papers/economic-market.html.

48 Neil Quigley 'The Economics of Harmonisation: Implications for Reform of Commercial Regulation in New Zealand', February 2003.

49 Refer, for example, to chapter 3 in the *Legislation Advisory Committee Guidelines*.

Governments should not regulate to remove common law liberties unless it is necessary to do so, the benefits from doing so exceed the costs, and the means employed respect important constitutional conventions. The emphasis on comparability and international standardisation noted above may raise doubts as to where the burden of proof should lie.

Quigley did not find support in the economics literature for any general presumption in favour of harmonisation. He doubted in particular that harmonisation would reduce the cost of capital for New Zealand firms. The final sentence of his summary is close to Drake and Goddard's position, and has the virtue of being clear about where the burden of proof should lie:

> Any case for the adoption of legal and regulatory frameworks from overseas must therefore be made on the basis of the superior efficiency of the foreign approach when it is applied to firms operating in New Zealand.[50]

Is New Zealand different?

Differences in market characteristics could justify different rules. Competition policy work by the Institute for the Study of Competition and Regulation in Wellington has identified distinctive features of the New Zealand economy. One is that industries tend to high concentration ratios. Such features point to the likely desirability of different competition policy regulatory arrangements for New Zealand.

The same logic applies to securities market regulation. One distinctive feature of the New Zealand sharemarket compared with the major markets is the degree to which listed companies are closely held.[51] Brian Gaynor cites 1993 statistics that indicate that a majority had a controlling shareholder.[52]

Such a feature reduces the monitoring problems associated with the separation of ownership and control.

> It is well accepted that mandatory disclosure requirements are not nearly as necessary in a culture where they are concentrated than in the U.S.-style corporation that is characterized by dispersed ownership.[53]

Are overseas securities market regulations sub-optimal?

There can be no presumption that any country's parliamentary laws are efficient even for that country. This is because the incentives of politicians, regulators and officials are not well aligned with those of investors.

Decades of empirical research indicate that government regulations are more commonly motivated by special interests than by the public interest. In the words of a major textbook on the economics of regulation, the theory that government regulations exist in order to improve community welfare "has lacked supporters for several decades" in part because "a large amount of evidence … refutes it".[54]

Banking regulation, for example, is widely agreed to have had the effect of increasing systemic risk by reducing financial stability. In the United States it long sought to

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50 Quigley, *op cit*, p 2.

51 See table 4 in Himmelberg *et al*, *op cit*.

52 Gaynor, in Walker and Fisse, *op cit*, pp 12-13.

53 James D Cox, 'The Death of the Securities Regulatory – Globalization', draft 18 March 2002.

54 Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E, *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, 1995, p 326.

protect small banks from competition from financially, stronger larger banks. It also weakened large banks by limiting their ability to diversify. Bank regulation contributed to the bank failures that led to the Great Depression of the 1930s.[55] Globally, it is now recognised that the moral hazard problem is widespread, "and hence explains in part the recent worldwide banking crises of the last twenty years".[56]

The history of securities market regulation, in the United States at least, seems to be much the same. Professors Henry Manne and Joseph Bial recently stated that:

> American securities regulation consistently has benefited politically powerful financial interests, and only competition and new forms of communications technology – not the SEC – have disrupted those cosy arrangements.[57]

A notorious example – regulation of takeovers

Takeover laws provide a classic example internationally of securities laws that protect a powerful incumbent group from hostile takeovers at the expense of investors. The effects are potentially very serious for corporate performance. Many finance experts in corporate governance see the hostile takeover as a major mechanism for disciplining poorly performing boars and managements – ie for achieving corporate control. The empirical evidence that hostile takeovers are in the interests of shareholders overall is overwhelming.

An active takeover market provides an incentive for independent large active shareholders to monitor the performance of incumbent management teams with a view to taking their companies over and throwing them out if they are not performing. Shareholders control this process in deciding whether to sell.

With the notable exception of the New Zealand Business Roundtable, interests that represent incumbent boards and managers commonly lobby for regulations likely to shut down this mechanism of corporate control. In the United States they have largely succeeded, according to Harvard University's Michael Jensen.[58] He has argued that this occurred from around 1989 as a result of court decisions, state anti-takeover initiatives and restrictions on the availability of finance (eg for leveraged management buy outs).

In New Zealand, mandatory disclosure rules forcing the publication of substantial shareholdings and the Takeovers Act 1993 have surely raised the costs faced by active investors and thereby undermined their role in monitoring management performance. To the degree that these rules lead to less concentrated ownership of New Zealand companies, they will increase the separation between ownership and control. Rules that inhibit large block shareholdings may also weaken the company's ability to cope with a sudden major financial crisis. A large shareholder can stabilise a company by supporting an injection of new capital in a crisis.

55 Randall Kroszner, 'Rethinking Bank Regulation: A Review of the Historical Evidence', *Journal of Applied Corporate Finance*, Vol 11, No 2, pp 48-58. See also Charles Calomiris, 'Banking Approaches the Modern Era', *Regulation*, Cato Institute, Summer 2002, pp 14-21, and James Barth, Gerard Caprio and Ross Levine, ' Bank Regulation and Supervision: What Works Best?', NBER Working Paper series, W3923, November 2002.

56 James Barth, Gerard Caprio and Ross Levine, 'Financial Regulation and Performance: Cross-Country Evidence', World Bank Working Paper 2037, January 1999.

57 Henry Manne and Joseph Bial. 'Questioning the SEC's Crusades', *Regulation*, Cato Institute, vol 24, No 4, Winter 2001, p 8-9.

58 Michael Jensen, 'The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems', *Journal of Finance*, July 1993.

Consistent with the self-interest of incumbent managers and directors, New Zealand's current restrictive arrangements were (and are) supported by the Institute of Directors. Also suggestively, they impose an option that was overwhelmingly rejected by small and large shareholders when voting under the stock exchange's earlier regime. Grant reports that only two companies out of more than sixty chose the restrictive 'minority veto' regime.[59] Small and large shareholders voted in separate classes in acknowledgment of the argument in the media that there was a conflict between the interests of small and large shareholders. However, this separation proved to be unnecessary in practice in that voting was commonly unopposed, reflecting the absence of opposing views prior to the motions being put.

The argument that the imposed code was in the interests of shareholders is also inconsistent with the fact that it does not allow small shareholders to vote for a different regime, company by company (even with the permission of large block shareholders). Another argument was that United States institutional investors would not invest readily in New Zealand unless New Zealand adopted this code. However, I understand that key features of the New Zealand code, such as the mandatory bid rule and the equal pricing rule (outside tender offers), have no parallel in the United States federal law.[60] In the event, it has not stopped United States and United Kingdom institutional investors from 'decreasing their exposure to New Zealand, contrary to impression created by a Merrill Lynch survey in 1999.[61]

The costs of legislation that makes takeovers more costly arguably dwarfs any transaction cost benefits from harmonisation. A single takeover bid for a sizeable company could well create hundreds of millions of dollars of value for its shareholders. The transaction costs to shareholders of having to hire lawyers who understood the differences in takeover regimes between two countries could not possibly be large enough to make up for this difference.

In the absence of an active market for corporate control, greater reliance must be placed on internal corporate control governance mechanisms. This is the current thrust of legislation in the United States.

There are good reasons to doubt that reliance on internal control mechanisms will work. Jensen has presented a great deal of evidence in support of his view that internal control mechanisms have widely failed to address the problems that were being effectively addressed by the wave of hostile takeovers and leveraged management buyouts in the United States in the 1980s.[62] Indeed, to the degree that boards are further diverted from focusing on shareholder value maximisation by 'stakeholder' theories, 'triple bottom lines' or diffuse notions of 'corporate social responsibility', the failures of internal control mechanisms are likely to be exacerbated.[63] The Enron case amply illustrates the limitations of 'exemplary' internal control mechanisms.

> Enron's corporate governance control system was regarded as state-of-the-art: externally by hiring one of the best accounting firms in the business, and internally through checks

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59 Grant, *op cit*, p 354.

60 See Bryce Wilkinson and Amnon Mandelbaum, chapter 34 in Walker and Fisse, *op cit*.

61 Armstrong, *op cit*. See also, ‘US Investor Sells down US Holding’, *Evening Post*, 9 August 1999 and Paul Swain, 'Does Takeovers Code protect investors or entrench directors?, *National Business Review*, 1 June 2001.

62 Michael Jensen (1993), *op cit*.

63 Michael Jensen, 'Value Maximisation, Stakeholder Theory, and the Corporate Objective Function', 2001.

> and balances such as separate financial, accounting, risk control and legal offices reporting in at the same level. In their congressional testimonies, Enron's outside directors remained resolute in their belief that they were diligent and dedicated to their charge …[64]

Concluding comment

The correct policy objective should be to have efficient capital markets. Initiatives relating to harmonisation and coordination are only relevant to the extent that they contribute to the efficiency objective. Neither is an independent objective.

If there is to be a presumption when considering what can be learnt from government regulations in other jurisdictions, a large body of empirical research and economic theory suggests that it should be that such regulations are unlikely to promote the general welfare, even in the home country.[65]

Moreover, under New Zealand's constitutional conventions, there should be no presumption in favour of government regulation that overrides common law rights. The rights of members of a club or stock exchange to choose their own laws or of shareholders to contract for their own articles should not be abridged, except for good reason and following sound processes.

By the same token, legislation that deprives shareholders of the opportunity to vote for arrangements of their own choosing should automatically attract suspicion as to whose interests it is really serving. Takeover and insider trading laws commonly have this suspicious character.[66]

Will the government achieve its objectives?

> There are a good many things about which it is better not to legislate. Legislation gives the state its legitimate authority to exercise its coercive powers over citizens and should not be entered into lightly. The wholesale creation of new criminal offences in an effort to regulate behaviour often creates great problems in law enforcement and leads to community disrespect for the law. New Zealanders have failed to appreciate the limits on legal sanctions as a means of ordering society; moral purity cannot be brought about by legislation.[67]

Introduction

The government's hope is that there will be greater investment in the New Zealand sharemarket as a result of improved confidence from greater regulation. However, it is possible that the higher regulatory costs and risks for company managers and market professionals will reduce investment, access and liquidity. Lawrence has posed the question well in an Australian context as follows:

> The remark has been made that it may be preferable to have stringent securities laws in order to improve the confidence of overseas security market participants who will then feel comfortable investing in the domestic economy. The conclusion is too clever by

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[64] Michael Asato, 'Corporate Governance, Adaptive Efficiency and Open Society' section V. (This can be downloaded from http://www.isnie.org/ISNIE02/Papers02/asato.pdf)

[65] Of course, this is a statement of general tendency. It does not prejudge the efficacy of any particular regulation.

[66] See Richard Epstein, *op cit*, and in *Controlling Company Takeovers: By Regulation or By Contract*, New Zealand Business Roundtable, December 1999.

[67] Palmer, G and Palmer, M, *Bridled Power: New Zealand Government Under MMP*, Oxford University Press, Auckland, 3rd edition, 1997.p 151. See also Lon Fuller, *The Morality of Law*, Yale University Press, New Haven, 1969.

> half: overseas investors are also bound by securities regulations and bear a portion of the associated regulatory costs. Importantly there is little evidence that overseas investors prefer more stringent rules. If the regulatory costs flow through into Australia's economic performance then the performance of the securities acquired by the overseas investors will be similarly affected.[68]

In New Zealand the legislation passed since 1988 been not obviously been helpful in attracting incoming investment. To the contrary, there seems little doubt that New Zealand has since fallen off the world's radar screen since the mid 1990s from an investor and trading perspective. The worlds' major investment banks have largely pulled out of New Zealand and the head offices of many banks and life offices have retreated to Australia.

A government's attitude to economic growth, privatisation and security in property rights is important for investors and the vitality of a domestic securities market. This would imply that much government policy in the last decade would have tended to discourage overseas investment. Higher tax rates and greater regulation are not the path to faster economic growth (see below).

The government's aims were set out at the start of this paper. The following sections consider how far they are likely to be achieved.

Will investors be better informed?

> After fifty years, the proponents of regulation have no scientifically acceptable evidence of net benefits of any disclosure rule that rests on reducing fraud or increasing confidence.[69]

The great hope of the proponents of mandatory disclosure is that it will improve market performance. The case for this is not self-evident, however, in theory or in practice, as the opening citation illustrates. In support, a recent review by Cato's Craig Pirrong finds that it is difficult to conclude "exactly how mandatory disclosure has affected markets". He also reported the absence of any consensus on the economics of disclosure and insider trading.[70]

It is not hard to assemble a list of the reasons why mandatory disclosure is not necessarily a good thing. For example:

- it may benefit competitors rather than shareholders
- companies will have a reduced incentive to invest in information to the degree that disclosure laws force it to be shared with competitors prematurely;
- fewer companies may list and investors may invest in more unlisted companies about which relatively little information is available;[71]
- shareholders may be so deluged by ill-interpreted information that their confidence in its management is undermined (see below for an example);
- companies are likely to find it harder to hire and to retain skills (see below also);
- brokers may have less incentive to produce company research;[72]

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[68] Lawrence, *op cit*, p 8.

[69] A quote attributed by Lawrence, *op cit*, to Frank Easterbrook and Daniel Fischel.

[70] Craig Pirrong, 'A Growing Market', *Regulation*, Cato Institute, Summer 2002, pp 30-37.

[71] Refer to the reasons why Marshall Software did not list in 'Why outsiders snap up good Kiwi companies', *The Independent*, 26 February 2003 and to the comments in 'NZSE sees gold in them thar banks', *National Business Review*, 21 March 2003.

- active investors whose shareholding purchases must be disclosed may have a reduced incentive to monitor the performance of potential takeover targets; and
- retail investors may rely more on informal, unqualified, views because professional sources of advice have become more costly and overly qualified.

Large firms and institutions do not need the government to force disclosure. They employ their own research professionals and are powerful enough (through their shareholding potential) to demand answers from companies.

On the other hand, retail investors need experts to interpret the information for them. The average retail investor has neither the time nor the expertise to process a mountain of technical information. The disclosure of voluminous facts and the publication of investment prospectuses that many of them cannot understand do not tell them what many really want to know: "do those who have expert knowledge and who are independent think this is a good investment or not?" Free broker research is one source of supply, but even it may be too technical; its real value may arise from the broking firm's reputation.

It would be helpful if those promoting mandatory disclosure provided more research on the number of retail investors that actually read and understand the expensive material that they receive in the mail. It would also be helpful if retail investors were surveyed to determine whom they actually went to for investment advice – family, friends, neighbours, free broker newsletters, or fee-charging professionals? Is there an undue focus on the last of these sources?

What is badly needed in the discussion documents is a better developed framework for thinking about the issues of information concealment and disclosure. Its apparent absence is particularly regrettable in that Professors Richard Epstein and George Benston have contributed independently to the New Zealand debate on the conflict between these two approaches.[73]

Will share prices be less distorted?

In a New Zealand context, a recent analysis by Jeffrey Lawrence cautiously concludes that the 1988 insider trading measures and the Companies Act 1993 measures "did not, and do not have, a discernible influence on stock prices nor, under currently employed definitions, did they positively influence market confidence".[74]

Greater share price volatility seems likely for several reasons. One is as a result of shareholders' confusion and alarm (or undue excitement) about how to interpret the release of under-analysed, piecemeal and sequentially contradictory information.

Another is the risk that markets will become less liquid. This will make prices more volatile. Several factors could make secondary markets less liquid. One is the possibility of less takeover activity and (legal) trading by insiders. It seems likely that even if shareholders might prefer insiders to own shares so as to better align their interests, insiders may prefer not to own shares at all simply because of the

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72 *The Economist,* 'Wall Street: No Rest', 1 March 2003, p 67, saw this as being one of the most perverse outcomes of the current investigations into the independence of broker research.

73 Richard Epstein, The Concealment, Use and Disclosure of Information, New Zealand Business Roundtable, August 1996, and George Benston, Voluntary vs Mandated Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure, New Zealand Business Roundtable, May 1977.

74 Lawrence, *op cit*.

reputational risks. Another possibility is that the proposed regulation of 'market manipulation' could reduce professional trading by raising the costs and reputational risks of market making.[75] The less the role for professionals, the greater the role for noise traders and speculators.

Will investors be better protected?

If a century of disclosure regulation has not adequately protected investors, it is worth asking what the basis is for thinking that more of the same will do better. Nothing can eliminate fraud and folly from human affairs or the cry for governments to 'do something' when money has been lost.

It is important to bear in mind that investors are not simply concerned with the risk of fraud. In countries with good legal systems, they need to worry more that managers might destroy shareholder value. Here the concern of finance experts that legislation in respective of disclosure and takeovers is seriously weakening corporate governance disciplines deserves serious consideration.

Indeed, much of the securities legislation passed since 1987 weakens the role for shareholder consent or 'voice' as a corporate control mechanism.[76] It rests on the dubious proposition that state regulation can better protect shareholders than can shareholders themselves.[77]

(Of course these features are not specific to securities market regulation. The common pattern in respect of much securities, labour market and consumer safety regulation is that investors, workers and consumers must lose common law freedoms of contract in order to save them from being 'ripped of' by business. The presumption seems to be that business is inherently predatory by virtue of the profit motive and those who deal with it are not capable of exercising their freedoms well. Adam Smith's insight – that it is self-interest, the profit motive and competition that induce the butcher, the brewer and the baker to supply us with what we need – not altruism (or meddling government rules), seems to have been either never learnt, or lost.)

Will companies perform better for shareholders?

Company boards cannot perform for shareholders if directors are tied up in red tape.[78] Nor can they perform if they cannot attract competent external directors because of these regulations and draconian penalties.

One sign of an excess of red tape and a potentially great liability is the prevalence in legislation of words that are so imprecise that directors may not know what they have to do to comply. Here are some examples:

[75] Ludger Hentschel and Clifford Smith, 'Risk and Regulation in Derivatives Markets', chapter 34 in Donald Chew, *The New Corporate Finance: Where Theory Meets Practice*, Irwin McGraw Hill, 1999, p 458.

[76] In particular, shareholders cannot vote for their own disclosure requirements, takeover regime or insider trading arrangements. Nor can members of the stock exchange in relation to such aspects in its listing rules.

[77] Mike Hulbert, 'Who Best Protects Shareholders? The Shareholders', *New York Times*, 4 November 2001,

[78] See Ivor Francis, *Future Direction; the Power of the Competitive Board*, Pitman, Melbourne, 1997 and Jeffrey Sonnenfeld, 'What Makes Boards Great, It's not rules and regulations, it's the way people work together', *Harvard Business Review*, 2002.

- The continuous disclosure rules require publicly listed companies to give any "material" information not "generally available" to "the market" to the NZSE "immediately" so that it can be publicly disseminated.
- Section 37(A)(1)(B) of the Securities Act 1978 is violated *inter alia* if a security offered to the public is associated with a "material" particular that is "false or misleading" in failing to give "proper emphasis" to "adverse" circumstances.
- The SC report on the recent Vertex case implies that all directors need to understand and apply correctly the (bureaucratic) distinction between a "projection" and a "forecast", to know what level of "information about risks" is "sufficient" and to understand what the SC means by "equal emphasis".
- Obligatory, but premature, releases can confuse and alarm investors and undermine confidence in the company. Baycorp Advantage's chairman recently reported that his board had to meet at 6.30 am to try to determine if a drop in sales was seasonal, or a 'trend". The subsequent drop in the share price reportedly led some shareholders to talk of his termination.[79]
- The insider trading legislation and anti-takeover legislation similarly create major penalties for violations of many artificial distinctions concerning the definitions of "price sensitive", "insider", "in confidence" and the like.

The emphasis on draconian penalties for directors and managers in much of this legislation can only serve to drive boards to focus on legality and compliance rather than on creating shareholder wealth through providing better value for money for the firm's customers.

The drive in securities regulation to force the disclosure of information contrasts starkly with the policy drive elsewhere to preserve privacy and protect intellectual property. The forced publication of senior managers' salaries illustrates the boundary problems between these opposing forces.

> Companies are required to amass talent and intellectual property and create value, that's critical for the community. Looked at that way, the last thing I would ever want to disclose are contracts of our most talented people [sic].[80]

Another risk for company performance is that regulatory delays will impose great costs during a crisis by reducing company flexibility. The recent Air New Zealand collapse illustrates the problem.

These points are all additional to those made earlier in relation to the weakening of the market for corporate control and the block shareholding ownership structure.

Will there be greater access?

The direct costs and burdens of listing on the NZSE undoubtedly already deter some initial public offerings (IPOs).

> Sharemarket listing locally would have increased our compliance costs and bureaucracy, taking critical management focus away from our core business challenges.[81]

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[79] Michael Coote, 'Weldon Walks a Fine Line', *National Business Review*, 14 March 2003.

[80] Commonwealth Bank chief executive, David Murray, as reported in 'Top pay disclosure ' incredibly difficult', *Australian Financial Review*, 19 March 2002.

[81] On why Marshall Software did not attempt an IPO 'Why outsiders snap up good Kiwi companies', *The Independent*, 26 February 2003.

Bruce McLachlan, head of business banking at Westpac, recently made a similar point in relation to the direct and indirect costs of listing.[82]

Will there be greater confidence?

> The recent debate over the appropriate level of securities market regulation has tended to proceed on the basis that more stringent regulations will improve market confidence. The theoretical foundation and empirical reality of such a contention is rarely challenged. There is however a growing body of empirical research which supports the notion that regulatory policy is not a significant determinant of stock price levels.[83]
>
> … if the government considers market confidence and overseas investment to be desirable goals, their efforts might be better directed towards improving macroeconomic performance rather than imposing more stringent corporate laws with their concomitant increase in compliance costs and the consequential reduction in the competitiveness of Australian companies.[84]

There may not be greater confidence in the New Zealand sharemarket if we enter a period in which business is brought further into disrepute because of technical violations of complex and vague new laws. The Vertex case is no doubt worrying many directors.

This effect may be exacerbated for a period by any regulatory enthusiasm for making an example of a ‘tall poppy’ in order to show that (a) the regulations have teeth and (b) the regulator is not in the pocket of 'big business'. The political attacks on the Building Industry Authority over leaking homes no doubt worry other regulators.

Another risk is that in the absence of higher economic growth or more privatisations, the NZSE may feel pressured to accept companies for its AX board that bring with them too many risks to its reputation. Bad investor experiences may tend to undermine the reputation of the sharemarket as a whole.

These points are in addition to the concerns considered above of increased price volatility and reduced market access.

Will there be a lower cost of capital and more investment?

Investment is driven fundamentally by 'Tobin's q'. It will be high when the market value of capital exceeds its replacement cost. This is the time when the sharemarket is likely to attract many IPOs. A high 'q' results from confidence in the future economic outlook in general and the future growth in company earnings in particular.

The proponents of these regulations hope instead (or in addition) that more stringent regulation will lead to the greater investor confidence and more investment from a lower cost of capital. However, as the above discussion has illustrated, it is easy to make a case that the opposite could occur. Reduced liquidity, weakened governance arrangements and excessive 'red-tape' could strangle wealth creation and reduce 'Tobin's q'.

Regulatory creep

There will be no limit to the *demand* for further regulation. Having put intrusive regulations in place with plenty of assurances that they will work, the pressure will be on the regulators to demonstrate that they do work.

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82 ‘NZSE sees gold in them thar banks’, *National Business Review*, 21 March 2003.
83 Lawrence, *op cit*, p 24.
84 Lawrence, *op cit*, p 13.

Yet no amount of regulation will prevent technical violations, commercial losses, fraud, or the problem of not very competent advisers. The more intrusive is regulation, the greater the frustration with delays, bureaucracy and rigidities. Furthermore, the more markets develop substitutes for the regulated products and activities, the greater the pressure to extend the regulatory net to encompass these new activities and products.

The difficulty is to limit the *supply* of state regulation to principled and justified purposes. This is not the natural inclination of politicians.[85] Nor, since the basic philosophy underlying these laws is that it is regulation, not competition, that makes businesses honest, is there any obvious principled basis for resisting regulatory creep.

The path not taken

Price earnings multiples in the sharemarket would be higher if investors had greater confidence about the general economic outlook. The key elements would be lower taxes, less regulation and privatisation of state trading enterprises.[86]

Such policies enhance economic freedom – the lodestar for economic growth.[87] Privatisation would also bring more depth and liquidity to the sharemarket.

Quality institutions – political stability, property rights, legal systems, patterns of land tenure, etc – count most for economic welfare and liberty. Easterly and Levine include New Zealand amongst the countries in which Europeans settled in large numbers and created institutions to protect private property and curb the power of the state.[88]

In respect of capital market regulation, the goal would be to achieve efficient capital markets. Their key role is to efficiently match the needs of suppliers and users of funds. Efficient capital markets would contribute to economic growth.[89]

Efficient arrangements could be expected to restore a greater degree of shareholder democracy. Unless there are compelling reasons to the contrary, shareholders should enjoy freedom of contract and therefore of choice in relation to such matters as takeovers, disclosure and insider trading. By the same token, members of a stock

[85] The prime minister "said that the Government's role was whatever the Government defined it to be", according to the *Dominion Post*, 4 March 2003.

[86] Under the earlier light-handed regulatory regime for telecommunications, the privatisation of Telecom was associated with enormous benefits from consumers and investors. For many years Telecom was a major source of the NZSE's vitality and strength. For more on the benefits of privatisation, see Phil Barry, 'The Changing Balance between the Public and Private Sectors', New Zealand Business Roundtable, 2002.

[87] Wolfgang Kasper, 'Losing Sight of the Lodestar of Economic Freedom: A Report Card on New Zealand's Economic Reforms', New Zealand Business Roundtable, 2002.

[88] William Easterly and Ross Levine, 'Tropics, Germs and Crops: How Endowments Influence Economic Development', National Bureau of Economic Research, Working Paper 9106, August 2002, and 'Economic Focus: The Roots of Development', *The Economist*, 5 October 2002.

[89] Thorsten Beck and Ross Levine, 'Stock Markets, Banks and Growth: Panel Evidence', NBER Working Paper No W9082, July 2002 and Thorsten Beck and Ross Levine, 'Finance and Sources of Growth', *Journal of Financial Economics*, Vol 58, No 1-2, January 2000, pp 261-300, Ross Levine and Sra Zervos, 'Stock Markets, Banks and Economic Growth', *American Economic Review*, Vol 88, 1998, pp 537-558, and Ross Levine, Noram Loayza and Thorston Beck, 'Financial Intermediation and Growth: Causality and Causes', *Journal of Monetary Economics*, August 2000, pp 31-77.

exchange would enjoy of freedom of choice in relation to listing rules and the like. Investors and issuers are better protected when government laws do not impede competition from other exchanges or means of intermediation.

The *quid pro quo* for greater freedom of contract is greater reliance on, and acceptance of, *caveat emptor*. People cannot be free if they do not take responsibility for their decisions. In time this would help restore incentives to invest in reputation.

Enforcement problems with long-standing laws should be thoroughly analysed and contending solutions to the underlying problems assessed. It makes little sense to add new restrictive laws if the real problem is the lack of enforcement of sound laws. Improvements to common law sanctions for self-dealing would be considered.[90]

Taking public policy analysis seriously

The future health, if not viability, of New Zealand's capital markets could be at stake on the basis of the concerns raised in this paper. New Zealand is a small market and the regulatory costs from a high cost approach to regulation that might be bearable spread over a larger market, could sink a small one.

Currently, there is little evidence that policy alternatives are being taken seriously. Simon McArley recently summed up his perception of the debate as follows:

> But will these measures clean up the market or just increase compliance costs? To some extent the argument is irrelevant. The truth would seem to be that when it comes to security markets, perception is as relevant as reality. A weighty volume of securities law adds to the perception that the market is well regulated and fair. While few overseas investors will undertake a thorough evaluation of the effectiveness of market regulation, many will be comforted by its existence.
>
> However, lamentable this may be for the academics and public policy commentators, it's an unfortunate fact of life. So ignore the quality and feel the width.[91]

This essentially envisages that the supply of regulation be unprincipled and demand-driven. It has a 'last one out turn off the lights' ring to it. To (some) economists, it is reminiscent of John Maynard Keynes (infamous) declaration that "in the long-run we are all dead'. Such 'short-termism' is irresponsible and ultimately unsustainable, as was the 'Keynesian' economics that followed Keynes.

Concluding remarks

The international evidence reviewed in this paper indicates that New Zealand was extremely fortunate to inherent sound English legal institutions. As a result its capital markets have had, at least until recently, a sound and favourable legal basis.

As the history of the stock exchange by David Grant highlighted, reputation has always been extremely important for those who intermediate between the investors who supply the funds and the businesses that use them.

Laws that create a legal minefield for directors, managers, market traders and insiders with no 'safe harbours', are the greatest threat to those who are the most honest and

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90 For a list of areas where common law sanctions, such as the *ultra vires* doctrine, have been weakened, see Alexi Marcoux, 'Business Ethics Gone Wrong', *Cato Policy Report*, Vol XXII, No 3, May/June 2000, p 11.

91 Simon McArley, "Another dose of securities law to bolster investor confidence', *The Independent*, 4 December 2002.

those who have made the greatest investment in reputation. Two questions that those promoting ever more stringent regulation and more severe penalties should ask are: "who would want to be a director?" and "how many independent directors of the hoped-for quality and integrity can be found in New Zealand"?

In the author's view, the marked withdrawal of the world's largest investment banks from the New Zealand market is also a concern. The reputational costs to them in their home markets from loose criticism by an ill-informed domestic regulator could swamp any profits they could hope to obtain from the relatively minute domestic market. The greater these regulatory uncertainties, the smaller the probability of their return.

There is a 'hollowing out' feel to what is occurring in New Zealand's capital markets. Current developments are raising the costs and regulatory risks of doing business and could be causing the flight of quality.

One of the biggest problems arising from the current (global) approach is the undermining of *caveat emptor*, and therefore the need to invest in reputation and trust. This is being undermined because governments are implicitly assuring investors that the government is doing the job for them. One plausible outcome is that investors will come to expect that when they lose money, the regulator will find that the company or the broker was culpable. In any case, the focus is likely to be increasingly on the regulator's performance in producing the necessary scapegoats and 'making an example' of people. Regulatory delays, ambiguities and costs may add to a sense of public unease and dissatisfaction.

It is hard to see how any market based on trust and reputation could survive the ongoing facile, prejudiced, ill-informed and reckless attacks on its integrity that the New Zealand Stock Exchange has had to endure in the media during the last 15 years. The ever-increasing compliance costs and legal risks for issuers and brokers risk further reducing the local sharemarket's chances of commercial survival. The temptation will be to resort to government protection from competition and other forms of support. This would reduce its efficiency and flexibility.

What might be done? At the most basic level, the presumption that more stringent regulation will raise investor confidence should be properly examined. Lawrence's two main conclusions from his review of this presumption seem worthy of much greater attention. They were:

(1) macroeconomic performance matters more than regulatory policy when it comes to establishing market confidence; and

(2) the regulatory costs associated with securities market regulations may actually impede macroeconomic performance.

The other thing that could be done is to return to the challenge posed by the 1991 Ministerial Working Group to better enforce long-standing existing law (rather than to add new laws that aggravate rather than alleviate enforcement problems).

With respect to the enforcement of these new laws (which include the troublesome insider trading laws passed in 1988) the dilemma is whether it is better to enforce bad law or to not enforce it. Either step brings the law as a whole into disrepute.

Here MED is to be commended for observing in its discussion document on insider trading law that the need for a clear policy justification is fundamental to its success.[92] New Zealand's 1988 law was a rushed response to the 1987 sharemarket crash, without the support of domestic or international experts in economics, finance and public policy analysis.[93] Nor were shareholders allowed to vote on the issue. The current review is an opportunity to put either or both matters right. Let us hope that MED has the courage to give it a go.

[92] Discussion document, Vol 1, p 20.

[93] See Fitzsimons, *op cit*, and Bryce Wilkinson, 'Insider Trading Legislation: Weak Analysis and Troubling Outcomes' in Rickett and Grantham (ed), *Essays on Insider Trading Legislation and Securities Regulation*, (1997).