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AIC MANAGED FUNDS CONFERENCE

**COMPULSORY DISCLOSURE: PROBLEMS AND
ALTERNATIVES**

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Introduction

The environment for saving and financial investment has improved substantially since 1984. Monetary and fiscal policy is more transparent and predictable. The rate of inflation has been lowered. Although the ratio of government spending and taxation to national income is still far too high, the government has become a net saver. The move toward tighter eligibility rules for superannuation and welfare benefits should encourage private saving. The rate of income tax faced by many savers has been reduced and different forms of saving are now taxed on a more uniform basis. GST, which is less biased against saving than an income tax, has been introduced. Deregulation of the financial sector has encouraged innovation and lowered the cost of services supplied to savers and investors. The removal of restrictions on outward capital flows has provided investors with access to a vast range of investment opportunities.

These positive developments have, however, been accompanied by the introduction, from October of this year, of new regulation of financial markets in the form of poorly conceived laws relating to investment product and adviser disclosure.

Concerns about mandatory disclosure stem from the desire to promote efficiency in financial markets. These markets play a key role in allocating resources among alternative uses and enable individuals to allocate consumption over their lifetimes. Efficient financial markets contribute to better economic performance and advance the overall welfare of the community.

The origin of the investment product and adviser disclosure legislation can be traced to the 1992 Task Force on Private Provision for Retirement. The Todd Task Force recommended that a specified minimum amount of information on investment products that are typically used by individuals for long-term savings purposes, such as interests in superannuation schemes, life insurance funds and unit trusts, should be made available to investors. It also proposed that people who offer financial advice be required to disclose their qualifications, experience and financial interests in any investment products on which they advise.

The Todd Task Force advocated voluntary saving for retirement backed by a tax-funded safety net. In an apparent attempt to deflect criticism that it supported a 'do nothing' option, the central recommendation was embellished with proposals on

disclosure. There is no evidence that they were closely examined. Afterthoughts by task forces pose a risk to sound policy because they can be implemented without proper evaluation. This proved to be the case with the disclosure recommendations.

The Hickey Working Group

Following the adoption of the superannuation 'Accord', based largely on the Todd Task Force's recommendations, the Working Group on Improved Investment Product and Adviser Disclosure, chaired by Elizabeth Hickey of Ernst and Young, was established to examine disclosure issues. The 1996 legislation largely followed its recommendations.

The fundamental problem which the New Zealand Business Roundtable had with the Working Group's exercise and the subsequent draft legislation was that it was not grounded on any proper research into the economics of information disclosure and the costs and benefits of government intervention to regulate the provision of information.

For example, the Working Group's reports did not take into account private incentives which encourage product issuers to disclose information on a voluntary basis. It made no effort to compare the information that was being made available by the market to investors in unit trusts, superannuation funds and insurance products with that which is to be included in investment statements and prospectuses. The claimed incremental benefits from additional disclosure requirements were shallow and unconvincing. Although the Working Group was required to examine the extent of any overlap between the proposals that it investigated and existing legislation such as the Fair Trading Act 1986, the Consumer Guarantees Act 1993 and the Financial Reporting Act 1993, its review was superficial and incomplete.

Our submissions on the various consultative papers and the draft legislation had a common theme: that a compelling case for an expansion of mandatory disclosure of information in respect of financial investments had not been made by the Todd Task Force, the Working Group, or any other body. The Working Group merely reported that a fundamental analysis of disclosure requirements was beyond its terms of reference. Nowhere, however, did it draw attention to this obvious shortcoming of its work. Instead it took the approach of the Securities Act 1978 as given and sought to achieve a degree of conformity among securities within the unsatisfactory framework of that Act.

At a practical level, a precise statement of alleged mischiefs, an evaluation of their frequency and seriousness, a careful analysis of the inadequacies of existing law and

its enforcement, and an assessment of the extent to which the proposals would remedy any shortcomings cannot be found in any reports or consultative papers that were produced. Moreover, higher compliance costs were to be imposed on investment advisers and brokers, and most issuers of investment products. It is baffling, to say the least, that the government accepted recommendations to introduce new regulations of this kind while telling us it is concerned about business compliance costs and is striving to reduce them.

The Working Group's approach fell well short of the standard of analysis that should be required to justify legislation which, in the words of the Securities Commission, "makes fundamental changes to New Zealand law about offering securities and to the way investment advisory business is conducted." Regrettably, in my view, it was one of the lowest quality public policy inquiries undertaken in recent years.

The Benston report

To test its own judgment, the Business Roundtable decided to commission an independent review of the Working Group's proposals. Its terms of reference focused on the choice between mandatory and voluntary disclosure. The underlying assumption in both cases was that general sanctions against fraud, misrepresentation and breaches of fiduciary responsibility would apply, and lawful contracts would be upheld.

The study was undertaken by Professor George Benston of Emory University, Atlanta, a distinguished academic and finance specialist. It was published in May 1997 under the title *Voluntary vs Mandated Disclosure: An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure*.

Benston found that some of the Working Group's disclosure recommendations were innocuous but that there was reason to doubt their usefulness to investors and no reason to believe that any uniform set of mandated disclosures could be effective for all investments and all investors. He reported that:

... the Working Group does not appear to appreciate the virtual impossibility of a government agency determining, with any meaningful degree of specificity, the information that individual investors would need to make informed decisions about different investment products. From a consideration of these requirements, it seems clear that disclosure [mandated] by a government agency or by legislation is likely, at best, to be incomplete or useless, and might be misleading.

Benston observed that the Working Group had failed to appreciate the benefits of voluntary disclosure:

Product providers have both the incentives and means to determine the information that prospective customers for their products might find useful. Importantly, less affluent and inexpert investors, for whom the costs of processing detailed information probably exceed the benefits therefrom, can 'free ride' on the efficiency with which the prices for publicly traded obligations reflect information.

Empirical studies of US stock markets cited in the study show that voluntary disclosure was commonplace among publicly owned companies prior to the enactment of government-required disclosure in 1933 and 1934. Other research found that mandatory disclosure provides little new information for investors.

Benston noted that with voluntary disclosure, product providers rather than consumers bear the cost of insufficient information. If consumers cannot readily evaluate a product, it is worth less to them. Hence the product will have to sell at a lower price to compete with an alternative investment that can be analysed more cheaply. Conversely, consumers will not recompense providers for the costs of providing excessive information. Furthermore, competition among product providers makes it likely that consumers will learn about alternatives.

Although providers with inferior products might be tempted to mislead or might fail to inform investors about their products' shortcomings, such actions are unlawful. In addition, competitors can gain from pointing out the shortcomings of such products. More importantly, product providers that intend to remain in business have a strong interest in establishing a good reputation for probity, service and expertise, particularly in a small country like New Zealand.

It might be argued that mandated disclosure is necessary to bring forth information that could be used by all investors (an externality) – in the absence of compulsion such information might be under-supplied. However, information is costly to produce, and it is not in society's interests to spend resources on supplying it beyond an efficient level. Benston argued that product providers have clear incentives to provide relevant information to potential investors, information services gather and publish such information, and there is no reason to believe that government-mandated disclosure would provide useful additional information.

The study found that government-mandated disclosure is likely to be very costly to investors. The direct costs incurred by firms to produce and publish the information

are actually borne by investors. Firms that are now preparing prospectuses and information statements for the first time will be well aware of such costs. Moreover, the experience of other countries that have mandated financial disclosure (notably, the United States) is that over time the requirements become more and more detailed and costly to fulfil. Despite these very high costs, there is no evidence that the US securities market has become more efficient since disclosure requirements were mandated or is more efficient than markets in countries with fewer requirements.

There is also a risk that non-expert investors might be misled into believing that the information they are given is adequate because it is government-mandated. Rather, investors should be advised to exercise due diligence about financial products and to investigate the reputations of those who sell them.

Weighing up the costs and benefits of voluntary versus mandated disclosure, Benston reported that the academic literature came down against compulsion. By imposing net costs, it discouraged rather than encouraged people to save. He found in favour of the alternative:

... voluntary disclosure driven by market forces. Competition among investment providers should be effective in giving investors the information they need and for which they are willing to pay.

Benston pointed out that:

... the people of New Zealand have, or could have, a wide choice of investments that offer varying degrees of information. They can purchase securities offered by firms that are subject to US, UK, Australian, Japanese, Singaporean and other countries' laws and regulations if they want the 'protection' and cost of these laws and regulations.

His report recommended that:

New Zealand should consider eliminating all but basic disclosure requirements on its companies. ... New Zealand law still would protect investors from fraud and misrepresentation. Giving New Zealand savers and companies more choice is ... the best way of achieving the mandate given to the Working Group – promoting the efficient allocation of the country's resources and enhancing peoples' willingness and ability to save.

Professor Benston's report has been favourably received and to date it has not been challenged in any academic or professional literature. We are aware of one criticism by Graham Rich, managing director of FPG Research Limited, who was reported in *The*

Dominion as saying that Professor Benston's argument was "flawed" and that the new rules were "very simple" and "low cost". This criticism cited no relevant financial literature or research findings. Furthermore, the view that the rules are very simple seems scarcely consistent with the 100 or so pages of legislation and regulations and the 60 exemption notices that have so far been needed to implement them.

The Business Roundtable is not alone in questioning the new legislation. The law firm Kensington Swan has made some pointed remarks. In a newsletter published in June it stated: "We question who will be the real beneficiaries of 'improved' disclosure – the mythical 'prudent but non-expert investor', or the printing and legal industries?" The Periodic Report Group (PRG), chaired by Jeff Todd, established to review progress on the private provision of income in retirement, reported in July that the disclosure legislation "had met with a mixed response." After summarising reactions to it, including Professor Benston's conclusion, the PRG recommended that "the new rules be reviewed once they have been operational for a reasonable period."

Experience to date with the disclosure regime

The new legislation came into effect on 1 October, although certain provisions relating to product disclosure are not obligatory during a six-month transitional period. Some of the regime's shortcomings are already apparent as the following developments illustrate:

- New Zealand account holders in Halifax Building Society were prevented from participating in a distribution of shares arising from its conversion from a mutual to a listed company. The issue took place before the rules came into effect. The Society reported that it would be too onerous and costly to comply with New Zealand laws including the new investment product disclosure rules. Account holders in some 30 other countries were able to take up shares. Although the Securities Commission stated that if it had been approached an exemption might have been granted, not all potential issuers are going to be bothered to seek exemptions from costly requirements. Moreover, a more relaxed approach to granting exemptions for foreign issuers would mean uneven terms of competition for domestic institutions;
- Kensington Swan reports that some providers of small employer superannuation schemes are examining whether to wind up their schemes or close them to new members because of excessive compliance costs. The costs of implementing the TOLIS (Taxation of Life Insurance and Superannuation Fund Savings) proposals are a further consideration. Other providers of such

schemes are investigating the possibility of admitting new members at a set time each year, for example once a year, to reduce compliance costs. These are bizarre outcomes from proposals that originated with a concern to encourage private provision for retirement;

- insufficient regard was had to the practical application of the new law. It is largely designed around discrete paper-based transactions despite submissions that urged the Working Group to have regard to technological developments and the vast variety of ways in which investments are arranged. How, for example, do financial institutions ensure that their obligations to provide investment statements are satisfied in respect of customers who transact over the telephone? How does an issuer that may be reliant on agents to distribute its product confirm that the investor has received an investment statement before investing? How many investors want to listen to a broker reciting procedures for handling money over the telephone before informing them about an offer of shares? What will be the implications of the Internet?

It is understood that the issue of whether employers, in addition to trustees, are the promoters of employer superannuation schemes has arisen. If this is the case, the directors of all employer companies that make multi-employer group superannuation schemes available to their employees will be required to sign the prospectus. A large cost could be incurred for what benefit?

Furthermore, there is excessive opportunity for investors to take advantage of procedural oversights to avoid their contractual obligations should an investment subsequently turn sour. Under the Investment Advisers (Disclosure) Act 1996 a loss may not need to be established by a person seeking damages for the failure to disclose information as required. This provision creates perverse incentives.

The government moved to amend the Investment Advisers (Disclosure) Act 1996 before it came into force. The amendment is aimed at clarifying the obligation of investment advisers, who do not normally receive investment money or property, to disclose information on their money-handling procedures. The problem identified was entirely predictable. Further amendments aimed at clarifying the legislation can be expected.

The impracticability of aspects of the new law will lead affected issuers and investment advisers and brokers to overlook some of their obligations, and regulators to turn a blind eye. This happens with the equally ill-conceived

insider trader law, for example in respect of underwriters whose role is not recognised. Laws which do not command the general support of the community, particularly those most affected, and which are not appropriately enforced, are bad laws. They undermine the integrity of our legal system and its institutions, and they encourage otherwise law-abiding citizens to break the law; and

- exemptions from the new disclosure rules have been approved which were not contemplated by the Working Group. Australian unit trusts, for instance, have been granted an exemption despite the recommendation of the Working Group that all overseas issuers be obliged to issue investment statements. The Working Group wanted every investor to have his or her hands held by New Zealand regulators. This was bound to restrict the access of New Zealanders to investments issued by non-resident entities, as the Halifax episode demonstrates. The exemption of a range of issuers is a small step in the right direction, but it is no substitute for rescinding bad laws.

Conclusion

The Business Roundtable has consistently argued that a major problem in the securities market area is that remedies which are available in cases of wrongdoing have not been employed. The quality and performance of the relevant public sector agencies rather than inadequate law is the principal issue. Moreover, financial losses and errant behaviour by a few issuers and investment advisers will not be prevented by the disclosure provisions that have been adopted. As George Stigler, a Nobel laureate in economics, wrote:

... we must base public policy not upon signal triumphs or scandalous failures but upon the regular, average performance of policy.

A *caveat emptor* approach must apply in the final analysis in the securities market as in any other.

The fundamental point which this discussion highlights is the need for a review of the Securities Act. The new disclosure legislation should not have been built on such outdated foundations. The Securities Act reflects an economic approach which is inconsistent with contemporary thinking on financial economics. In particular, the increased recognition of the importance of transaction costs, including information costs, calls into question the merits of much public regulation of the securities market.

It is true that the Securities Commission authorises individual or class exemptions to address some of the more costly effects of the Securities Act. The Commission's 1997 annual report states that 642 exemptions had been issued since 1983. Of these, 152 were in full effect, 309 had been revoked and 181 appeared to have no further application. In June 1997 there were 80 applications before the Commission. Activities related to exemptions comprise the first of the five categories in the Commission's work programme and the Commission is reviewing its policy on exemptions. The Commission believes that its power "to grant exemptions allows for the quick and low cost ability of issuers to introduce new and innovative products to the market". However, extensive use of exemptions points to fundamental flaws in the Act and such administrative discretion undermines the rule of law.

Australia is about to review its legislation relating to fund raising with the objective of making the law work for investors and companies rather than against them. Proposals to reduce the amount of information that issuers are required to disclose to retail investors and to lower the threshold for determining whether an investor is deemed to be sophisticated and not in need of special protection have been foreshadowed. They follow changes in the US law affecting mutual funds. The Australian and US reforms are aimed at reducing disclosure requirements, contrary to the thrust of policy recently adopted in New Zealand.

The Ministry of Commerce is to undertake a review of the present role and function of the Securities Commission. The starting point should be a basic examination of the Securities Act, which dates from the Muldoon era, and it should include a review of the investment product and adviser disclosure legislation. The analytical basis of the review should incorporate the findings in Professor Benston's report. The overall aim should be to correct the recent mistakes and permit financial markets to efficiently meet the needs of investors and the general community.

One approach that would be worth considering in such a review would be to allow opting-out from a mandatory disclosure regime, if there were a desire to retain some form of compulsion. It might be framed along the lines that an offeror or financial intermediary could opt out of securities law (but not law relating to fraud or dishonesty of other kinds) if it clearly warned in all its written communications about an investment contract it was offering that it might or might not comply with mandatory securities regime requirements and that the investor was effectively proceeding on a *caveat emptor* basis. A short form notation could be stipulated which would signal this opt-out status, just as 'limited' after a company name was used from the middle of the nineteenth century to signal the then radical standard limitation of liability in the conventional company. The 1858 prophets of doom (in relation to

limited liability companies) were proved spectacularly wrong. Trade thrived. There is little reason to suspect any different outcome with this proposal.

The net effect would be to create a competitive tension. It would curb the more ill-judged interventions of the regulators. If their regime did not add sufficient value to justify its costs, offerors and intermediaries would migrate to the 'unregulated' market. Investors would deal in it because the 'protection' of the regulations was not adding sufficient quality brand value or other protection to justify absorption of the compliance costs in the pricing of securities.

The regulators would then have to act, as the New Zealand Stock Exchange does now, to better balance the competing tensions between investors and issuers, seeking out the efficient frontier of incurring compliance costs to reduce information costs through standardisation. Such a scheme for exposing the regulators to internal competition could be coupled with an opening of the New Zealand market to international competition, on condition that any offering clearly identified the regulatory regime under which it is governed. The Securities Commission might develop a role of enhancing public understanding of the differences between regulatory regimes (from an investor perspective).

An alternative (opt-in) approach would be to only permit issuers to advertise that they complied with the regulatory code if they paid a charge to the regulator which covered the costs of providing this certification service, monitoring its use and prosecuting those who abused it. This fee would further sharpen the regulator's incentives to think about value for money for end users.

Maintaining some kind of regulatory regime while allowing opting-out or opting-in would have costs, and would almost certainly be inferior to a voluntary regime. On the other hand, if – as seems likely – the prescriptive regime is valueless, having regard to the balance of costs and benefits, there would be mass migration from it. It could be left standing as a comforting shelter for those who believe in official wisdom. There may be no great losses associated with letting a thousand flowers bloom, even regulatory clones.