Aspects of Market Integrity

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(1) There are many factors that impact upon the integrity of the financial marketplace. It is a shame that this is not an issue that is addressed as a matter of course on a regular basis, rather than one that becomes pressing because of a particular unintended effect of the market, namely the Global Financial Crisis (GFC) and its expected impact upon ordinary investors and retired superannuants

(2) My submission is primarily interested in the disclosure aspects that the Issues Paper raises; principally the idea that disclosure is required for a modicum of market efficiency

(3) Market efficiency *per se* is not something that can be achieved by regulation. Corporate regulation of a market, by definition, reduces efficiency. This is an economic reality, yet there lies a tension between ideal economic policy, and political risk associated with the presumptions around inadequacy of regulation

(4) Attempts to marry the ideals of economics and the perceived need for complex corporate regulation have been made via the Corporate Law Economic Reform Program (CLERP)

(5) The object of CLERP "is to ensure that business regulation is consistent with promoting a strong and vibrant economy… to promote business and market activity leading to important economic outcomes including increased employment, by enhancing market efficiency and integrity and investor confidence… [within] a clear and consistent framework" (ii)

(6) The summary statement of principle for the (CLERP) highlights the deficiency in approach by seeking to achieve, via regulation, inconsistent goals:

> "The focus of the reform agenda is to ensure that business regulation facilitates economic activity and job creation. The key principles underlying this review are as follows: market freedom… investor protection… information transparency… cost effectiveness… regulatory neutrality and flexibility… business ethics and compliance" (ii)

(7) Whilst the CLERP ideals are noble, one is stretched to opine that they have in fact been achieved, since by definition one cannot simultaneously have for example investor protection and market freedom, there must be a compromise

(8) Compromise by its very nature suggests a lack of perfection – given the strong political imperative for investor protection however vague that concept is in practice, the best means for ensuring protection, if it must be sought, is to insist on disclosure of all relevant information that might impact on an investor's decision to invest *and* the disclosure of all relevant information that might impact on an investor's ongoing decision to remain invested – this seems to be a reasonable compromise

(9) It is not recommended that the specifics of what is to be disclosed be outlined – such an effort will only encourage ways around disclosure – instead a reasonableness / objective test is suggested whereby a suitable arbiter determines whether or not the relevant information ought to have been disclosed (see (20-(23) below)

(10) Research around the regulation of corporate fundraising (CLERP) (iii) suggests that "changes in litigation risk affect the level but not the quality of disclosure… also suggest that the reforms' objectives of reducing fundraising costs while improving investor protection, have been achieved"

(11) What appears absolutely necessary is an increase in the amount of empirical research around changes to corporate regulation whereby variables such as "disclosure" and "investor protection" are defined, modelled and tested in at least an attempt to understand whether previous changes to the law have been effective. This might then go some way to determining the direction of future change

(12) Since the Australian regime has experienced difficulty in properly understanding, other than by way of opinion, anecdotal evidence and interest group lobbying behaviour, the precise ambit of an effective economic approach to regulation, it seems very dangerous to make comparative comparisons with other jurisdictions for answers to the disclosure issue that this submission seeks to address – it is essential that the Australian system is objectively understood

and where possible empirically verified before comparisons are made with other jurisdictions – at this stage, it is submitted that such comparison would hinder the inquiry

(13) On this basis then, it is difficult to imagine, in the absence of a breach of duty or potential conflict, why directors ought not to be able to purchase shares in the company of which they serve and following on from that – why it is necessary to limit the means by which directors finance the acquisition of those shares. Indeed it appears to be an anomaly to only limit the means by which directors finance a margin loan or margin call as distinct from a company loan for another purpose

(14) Any attempt to somehow limit the manner that a director makes a personal investment decision is difficult to understand – surely, given the widely accepted agency problem, the stronger the separation of ownership and control of the organisation is, the greater the need for effective stewardship – whilst there is an abundance of literature and opinion as to the most effective means of ensuring that directors act in the best interests of the company of which they are stewards, director compliance with shareholder preference, is to place no obstacles in the path of a director having a significant portion of their personal wealth invested in the company that they serve

(15) So long as director interests are disclosed to the public in full, there can be no harm in directors having a holding of company shares, acquiring shares or disposing of shares – full disclosure would be a very effective means of understanding the extent of alignment of shareholders' interests with those of the company's directors and would also assist the regulator in understanding and more properly determining whether a breach of the law has occurred

(16) The risk that may arise, if disclosure is ultimately required, is that directors will utilise more private arrangements (for example acquisition by a trust or superannuation fund) to make acquisition of company securities – nonetheless this might be easily required by regulation (to include related third parties) but be equally difficult to enforce

(17) It is therefore desirable for directors of publicly listed companies to properly disclose the extent that they are exposed to the fortunes of the companies they serve. This might also contemplate the inclusion of contracts, arrangements or understandings that benefit a director where the director has control (in a direct or indirect (related party) sense. It is difficult to imagine that the requirement of disclosure would result in an exodus of director talent from the market place and therefore, in the absence of empirical testing/understanding, ought to be trialled – section 205G ought therefore to be amended to a wider position that includes margin trading activity as contemplated by the Issues Paper and any other relevant behaviour that affects investors – in short, there are a range of reasons why share prices move (and how investor confidence is shaken) and opportunistic behaviour by directors and / or shareholders will not be halted by a particular regulation (or prohibition) around margin lending

(18) Where regulations are effectively implemented to ensure that full disclosure is made, the market mechanism, together with a properly resourced regulator, will ensure that director behaviour is monitored and understood more fully by the marketplace. It therefore follows that there is no need for 'blackout' trading by directors – note the proviso that the regulation is sufficiently funded to ensure that it is effective. It might also be worth considering the Australian Stock Exchange (ASX) Listing Rules in this context (particularly the continuous disclosure requirement of 3.1 that requires "timely disclosure" of information impacting upon "security values… investment decisions, and information in which security holders, investors and ASX have a legitimate interest") (iv)

(19) There is one other aspect that might be worth noting, namely the matter of individual shareholder responsibility – in the current state of the GFC there is a large amount of discourse on the responsibilities of directors and of government in ensuring that investor funds are safe. One of the risks of over-regulating, is the natural tendency of the person protected to seek greater protection or to relax their own need for due inquiry

(20) It seems apparent that where disclosure is required and is adequate, the tendency to induce reliance by investors becomes less of a problem thereby diminishing the need to protect an investor in a particular set of circumstances. This seems to be important since the likely circumstances for difficulties to arise are not often predicted with any degree of certainty thus resulting in *ex post* regulation that has much less impact.

(21) At some point it seems that the tide of complex regulation must slow down and, where that is seen to be desirable, reversed. It is therefore an important step to see disclosure as a means to that end – namely that adequate disclosure precludes the need for more comprehensive regulation around *particular* behaviour

(22) The regulation of particular behaviour usually occurs after a problem has arisen – it is therefore *ad hoc* in nature and does not necessarily contemplate (due to design, omission or sheer impossibility for complexity reasons) unintended outcomes/complications with the existing law. It seems that a move away from particular provisions might be more useful and importantly more generically applicable – that is a move to a more "fuzzy" stance on important issues such as disclosure, might enhance the position for investors and regulators and ultimately companies. (v)

(23) A "fuzzy" approach might also allow for codes of conduct to be taken more seriously since they more naturally fit within an atmosphere of voluntary compliance with general rules than a mandatory regulatory setting specifying particular rules

(24) It might be that investors *en masse* determine that they do not like one particular aspect of director behaviour that becomes disclosed in the course of events by more than one company – this might result in less interest from an investor point of view – the result might be changes to the affected company's constitutions (for example requiring disclosure by directors of margin loan arrangements or changes thereto) or the behaviour of the company directors – both of these possibilities of course occur in the absence of corporate regulation and are driven by investor demand

End of submission.

References and notes

(i) Dr David Morrison, TC Beirne School of Law, The University of Queensland, Australia and Visiting Professor, University of Illinois College of Law, United States of America, Spring 2007

(ii) Australian Government Treasury, CLERP – Policy Framework at http://www.treasury.gov.au/documents/267/HTML/docshell.asp?URL=index.asp accessed 1 March 2009

(iii) Chapple L, Clarkson P, Peters C *Impact of the Corporate Law Reform Program Act 1999 on initial public offering prospectus earnings forecasts* (2005) 45 Accounting and Finance 67

(iv) ASX, *Continuous Disclosure: Listing Rule 3.1* at http://www.asx.com.au/ListingRules/guidance/gn08_continuous_disclosure.pdf Accessed 5 March 2009

(v) Green J, *"Fuzzy Law" – A Better Way to Stop "Snouts in the Trough?"* (1991) 9 Company and Securities Law Journal 144