The Economics of Market Confidence: (Ac)Costing Securities Market Regulations

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When discussing securities market regulations, the discourse has traditionally been preoccupied with considerations of equal access to information, transparent disclosure and shareholder rights. In recent times, however, regulatory reviews performed by the Corporate Law Economic Reform Program and the Office of Regulation Review have directed attention to the need for efficient securities regulations which acknowledge the cost-benefit trade-offs inherent in any regulatory structure. Notwithstanding this growing awareness of regulatory costs, there still appears to be an overwhelming tendency when considering securities regulation to equate more stringent regulations with market maturity and, in particular, improved investor confidence. This article adopts a number of economic constructs to broaden the regulatory debate and it also raises a number of concerns in relation to the existing regulatory framework and the on-going regulatory debate. The main conclusions from this analysis are that, firstly, macroeconomic performance matters more than regulatory policy when it comes to establishing market confidence and, secondly, that the regulatory costs associated with securities market regulations may actually impede macroeconomic performance.

Introduction: The significance of securities markets

The securities markets are of major national significance performing, as they do, the economic function of raising, and promoting the raising of, capital and therefore economic activity in Australia.[1] The principal components of the global capital markets consist of financing activity in the areas of bonds, equities, syndicated loans, other committed debt facilities, euro-commercial paper programmes and medium-term euro-note programmes; with the largest part of total issues being accounted for by international bond issues.[2]

The dramatic growth in the international capital markets since 1992[3] has not altered the fact that Australia is still a junior actor on the global stage.[4] A small domestic capital market (due in part to a

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[1] Corporate Law Economic Reform Program, *Fundraising: Capital Raising Initiatives to Build Enterprise and Employment* (CLERP, Proposals for Reform: Paper No.2, 1997) 9 ("CLERP Fundraising"); Corporate Law Economic Reform Program, *Financial Markets and Investment Products: Promoting Competition, Financial Innovation and Investment* (CLERP, Proposals for Reform: Paper No. 6, 1997) 7 ("CLERP Financial Markets").

[2] Organisation for Economic Co-Operation and Development ("OECD"), *Financial Market Trends: 69* (1998) p 5, Table 2.

[3] Since 1993, international bond issues have increased by 173%, floating-rate issues have increased by 305%, syndicated credits have increased by 286%, medium-term euro-notes have increased by 362% and equity issues have grown by 210%: OECD, op cit n 2, p 107-124. On October 29, 1999 world developed equity markets' market

relatively small population base) contributes to the dependence upon international markets and increases the importance of a coherent and efficient securities regulation regime for our domestic economy. It has been noted on several occasions that larger economies, such as the United States economy,[5] can withstand the burden of some arcane and inefficient regulations due to the depth and liquidity of their domestic capital markets.[6]

Securities regulation encompasses all of the legal principles concerning "capital raising in the primary market by the issue of financial claims to investors and the trading of those claims in the secondary market."[7] In addition to securities regulations, the capital markets are also guided by corporate law, commercial codes, contract law, taxation law, insolvency law, trade practices (competition law) and the dispute resolution system.[8] In the Australian context, securities regulation generically refers to the manner in which a nation's capital markets and its participants are influenced by the regulators, the courts and the government. In particular, it relates to the control and direction of market participants in the sectors of the Australian economy pertaining to equity raisings and trading (the Australian Stock Exchange), and the derivatives markets (the Sydney Futures Exchange and, to a lesser extent, the Australian Stock Exchange).[9]

In most western cultures the role of securities regulation is to, amongst other things, promote market confidence and to ensure the development of a transparent and well-informed securities market where every market participant has equal access to information and participates on a level playing field. It does not seek to ensure that all investors make a return on their investment, nor does it seek to guarantee a specified yield. Securities regulation is guided by an equality of opportunity rationale, as opposed to focussing on equality of outcome.[10] However, securities regulation fulfils different functions in different cultures.

> "Asian cultures see regulatory regimes as ensuring the stability and strength of the markets and the economy as a whole, but the role placed on the [securities] market regulatory system

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capitalisation exceeded US$27.5 trillion for the first time. This represented a 50% increase of US$9.5 trillion (more than the entire nominal economic output of the United States) in equity wealth in slightly over one year: Citigroup Inc., *Salomon Smith Barney Developed Equity Markets Performance Report* (29 October, 1999) p 1.

[4] In 1997, a total of US$1,309 billion of debt and equity securities were issued on a global basis (a significant increase from a total issue of US$666 billion in 1993): OECD, op cit n 2, p 5. In terms of capital market borrowings, Australia was only able to access US$38.4 billion, or 2.2% of total borrowings, in 1997. The access to global equity issues was nominally even less, with only US$2.3 billion of issues, or 5.4% of total equity issues: Ibid at 50, 76. Similarly, Australia only raised 13.8% of global privatisation proceeds in 1997 (this year also represents Australia's highest proportion of global privatisation proceeds during the post-war period): Ibid at 48.

[5] R Romano, "Empowering Investors: A Market Approach to Securities Regulation" (1998) 107 *Yale Law Journal* 2359 at 2363.

[6] V Goldwasser, "Current Issues in the Internationalisation of Securities Markets" (1998) 16 *Company & Securities Law Journal* 464 at 483. Although, it should also be acknowledged that excessively costly policies run the risk of eventually contributing to the "explosion" of the market: Ibid at 477 n 96. By the same token, many of the US securities regulations have been adapted to accommodate risk taking and innovative behaviour. These positive regulations may disguise to some extent the detrimental effects of the inefficient regulations.

[7] G Walker, B Fisse and I Ramsay (eds), *Securities Regulation in Australia and New Zealand* (1998, 2nd ed) p xxvii ("G Walker et al").

[8] Notwithstanding the significance of these topics to the capital markets, they will not be examined in this review.

[9] Although the ASX and SFE have been proposing a merger for some time, the Australian Competition and Consumer Commission eventually blocked the proposed transaction: N Hopkins, "Merger Talk Fires ASX", *The Australian* (Sydney), 17 March 1999, p 23.

[10] International Organization of Securities Commissions ("IOSCO"), *Objectives and Principles of Securities Regulation* (1998, Consultation Draft), Principles E14, E15; J Galbraith, *A Short History of Financial Euphoria* (1990) p 109.

> in Anglo-Saxon countries is to ensure that markets are fair and that no single trader can manipulate the markets to gain an advantage over the other participants."[11]

Any assessment of a nation's securities regulation must be conducted by reference to the functions and importance of the relevant market. The economic role of the financial markets is to channel "capital resources or savings to those who will make the best use of them"[12] and in this regard the markets will theoretically ensure that there is "the least-cost transfer of financial resources from those with a surplus of funds to those that can use them more productively, and also the enhancement of the risk-bearing capacity of the economy... [as well as] ensuring that funds flow to the highest value uses"[13]. These functions are so intertwined with the development and competitiveness of our economy – all of which contributes generally to society's welfare - that the efficiency of the securities markets and the design of securities regulation is a topic worthy of national debate.

In the local region – naturally with the focus on Australia and New Zealand - there is in progress a long overdue debate regarding the efficacy of securities regulations and, importantly, this debate is occuring in the midst of radical developments in the form of economic and financial globalisation, technological change on a unprecedented scale and a growing awareness of economic cost-benefit analysis. While on its surface the topic of securities regulation sounds like a relatively 'tame' and perhaps even apolitical subject, brief reflection will reveal that the regulation of securities markets and its participants is an area of much political, philosophical, economic and legal controversy. The extent and content of regulation is bound to draw passionate and conflicting viewpoints from all quarters. Individual issues which relate to the securities markets - such as foreign investment, privatization and leveraged buy outs - are politically charged.

The prominent American jurist Frank Easterbrook has theorised that it is not the adequacy of a nation's laws which determines the strength of a country's stock market.[14] 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. In other countries, where such market based disciplines are absent, investors seek to discipline managers through the mechanism of corporate regulations which improve the rights of shareholders and which give more powers to regulatory bodies, creditors and institutional investors.

> "When capital markets are efficient, the valuation process works better; when markets are less efficient, some substitute must be found - law, perhaps, or the valuation procedures of banks. Thus we have greater bank roles in nations with less extensive capital markets [and] we have more law, too... To sum up: international differences in corporate governance are attributable more to differences in markets than to differences in law. Law is an output of the process, not an input. When financial markets are more efficient and interjurisdictional competition blooms, there will be less law and more investor protection at the same time."[15]

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[11] F Miley and A Read, "Cultural Differences in the Attitudes to Securities Market Regulation: The Case of the Barings Collapse" (1996) 7 *Australian Journal of Corporate Law* 105 at 117.

[12] M Heffernan, "The Economic Role of the Australian Stock Exchange" in G Walker et al, op cit n 7, p 129.

[13] B Birchall, "The New Zealand Stock Exchange and the Securities Markets in New Zealand" in G Walker and B Fisse (eds), *Securities Regulation in Australia and New Zealand* (1994) p 113 at 115; A Shaw and P von Nessen, "The Legal Role of the Australian Securities Commission and the Australian Stock Exchange" in G Walker et al, op cit n 7, p 174; CLERP Fundraising, op cit n 1, p 9.

[14] F Easterbrook, "International Corporate Differences: Markets or Law?" (1997) 9 *Journal of Applied Corporate Finance* 23.

[15] Ibid at 29.

This theory posits, therefore, that the strength of national stock markets determines the severity of the corporate and securities laws. Laws which protect shareholders respond to, rather than determine, the economic environment. There is some recent empirical research, however, which suggests that “the differences in the nature and effectiveness of financial systems around the world can be traced in part to the differences in investor protections against expropriation by insiders, as reflected by legal rules and the quality of their enforcement”.[16] From a theoretical perspective it is suggested that “countries with better legal protections should have more external finance in the form of both higher valued and broader capital markets.”[17] At the same time, there is still further empirical evidence which supports the notion that economic growth and macroeconomic stability are more important determinants of security market confidence and growth than is the severity of the securities regulations.[18] It is precisely this inter-relationship between law, economics and finance which warrants a closer examination of securities market regulation.

This article will revisit the economic rationale by which the effectiveness of securities regulations can be measured. It will do so by referring to both the benefits and the costs of securities regulations. Some of the purported benefits will be re-examined in light of recent empirical research and developments in legal and economic theory. In particular, the relationship between regulations and market confidence will be examined in some detail with reference to recent empirical research. The argument in favour of explicitly recognising regulatory costs during any reform process is based on several contentions. Central to this argument is the role of globalisation and harmonisation, overseas investor preferences, moral hazard and the behavioural impacts of innovation and adaptation. Furthermore, limited consideration will be given to a number of macroeconomic imperatives relating to inflation, unemployment and international competitiveness which, it is argued, are influenced by expensive regulatory costs.

In recent times, the issue of regulatory costs has been receiving increasing attention; even in lightly regulated economies such as New Zealand.[19] A number of Australian legislative reviews in recent times have demonstrated an awareness of regulatory costs which has been absent from the regulatory debate in the past. Those legislative reviews are briefly examined before contemplating the failure by both the legal and economic communities to incorporate and develop empirical research on regulatory costs.

A cost-benefit analysis of securities regulations

In order to evaluate whether society has constructed an optimal securities regulation regime, many observers would adopt an economic framework that examines the purported benefits of securities regulations and weighs against those positive influences the “costs” associated with the current regime.

On the other hand, within the legal community there is a substantial and growing body of economic, legal and philosophical literature which is generally critical (and, at times, dismissive) of the law and

[16] R La Porta, F Lopez-de-Silanes, A Shleifer and R Vishny, “Legal Determinants of External Finance” (1997) 52 *Journal of Finance* 1131 at 1131.

[17] Ibid at 1132.

[18] See n 81, below, and accompanying text; JJ Lawrence, “Market Confidence and Securities Regulation: Empirical Insights” (Working Paper, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1996); R La Porta et al, op cit n 16 at 1139-1140.

[19] OECD, *OECD Economic Surveys: 1997-98: New Zealand* (1998) p 8: ‘There is a need to address the costs of business regulations (mainly through compliance)… these initiatives should contribute to lifting potential growth and again making progress towards closing New Zealand’s relative-income gap.’; J Luxton, “Reforming Commercial Law” [1998] *New Zealand Law Journal* 271.

economics movement.[20] Nevertheless, it is still reasonable to suggest that "economics, in predicting and testing the impact, allocative and distributive, of alternative legal regimes, offers powerful and indispensable insights about the implications of alternative policy choices."[21] Indeed, it is disconcerting that the economics profession has not taken up the mantle on the areas of law and economics pertaining to regulatory costs. It is in the simple application of econometrics and even data collection and summation that the law and economics discourse can provide some very useful insights for the regulatory debate.[22]

> "Without empirical testing, it is simply not possible to get a better grasp of the positive question of how particular laws affect economic behaviour; nor, therefore, is [it] permissible to draw broad normative conclusions concerning legal policy in the absence of evidence."[23]

Applying basic economic analysis to the corporate form is useful for a variety of reasons. Not least among these reasons is that it "provides a remarkably clear lens through which the problems of corporate law and corporate governance can be viewed with clarity and precision".[24]

There are many ways in which society can evaluate the efficacy of its securities regulation and there are perhaps several methodologies by which those regulations can be optimised. The conceptual filter provided by economics allows the debate to shift consideration to matters such as "regulatory cost-benefit analysis", "opportunity costs", "macroeconomic implications" and "efficient enforcement".[25]

> "The acceptable resolution of disputes may involve balancing human rights and other values. But the efficient use of scarce resources and the economic implications of suggested alternatives can never be ignored, just as the decisions we make as individuals as to how we will spend our energies and our money there are always policy trade-offs between efficiency, fairness and other individual and community values."[26]

Although it may be trite, it needs to be stressed that a cost-benefit analysis (or a regulatory impact statement)[27] takes account of *both* costs and benefits. In assessing the "net regulatory burden" for any market jurisdiction, it is necessary to compare the incremental costs incurred less the marginal benefits

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[20] Exemplified by the perspective of former Chief Justice Mason of the High Court of Australia: A Mason, "Law and Economics" (1991) 17 *Monash University Law Review* 167.

[21] M Trebilcock, op cit n 49 at 156.

[22] Concerns over the efficiency of common law rules, while not trivial, are less compelling indicators of the benefits to be derived from economic analysis: K McGuinness, "Law and Economics – A Reply to Sir Anthony Mason CJ Aust" (1994) 1 *Deakin Law Review* 117; G Hay, "The Past, Present and Future of Law and Economics" (1996) 3 *Agenda* 71.

[23] S Deakin, "Law *Versus* Economics? Reflections on the Normative Foundations of Economic Activity" in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics* (1999) p 30 at 39.

[24] J Macey, "Corporate Law and Corporate Governance: A Contractual Perspective" (1993) *Journal of Corporation Law* 185 at 185.

[25] Which is not to detract from the valid concerns expressed about the legitimate ambit of economic analysis: M Richardson, "Book Review: *Economic Analysis of Law*" (1993) 19 *Melbourne University Law Review* 481 at 482: "there is still an important question of whether there are some areas of law which are inherently non-economic or for which the economic analysis is only of marginal relevance – where notions such as rights, fairness and general welfare must prevail over any possible economic considerations"; see also G Hadfield, "The Second Wave of Law and Economics: Learning to Surf" in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics* (1999) p 50.

[26] Sir I Richardson, "Law, Economics and Judicial Decision-Making" in M Richardson and G Hadfield (eds), *The Second Wave of Law and Economics* (1999) p 129.

[27] See below at n 116, below, and accompanying text regarding the Office of Regulation Review.

realised as a result of the regulation under consideration.[28] A cost-benefit analysis entails a thorough examination of whether market freedom can be justifiably curtailed on the basis that 'there are clear regulatory objectives and the benefits of intervention outweigh the costs.'[29] This ensures that the proper consideration of costs is not synonymous with conservatism nor does it necessarily entail policy paralysis.

> "Government inaction has costs of its own; it may allow severe problems to continue; and some forms of cost-benefit analysis actually fail cost-benefit analysis. They impose extensive informational demands on agencies. They create excessive delay. They obstruct desirable regulation. Thus efforts at regulatory reform should avoid the pervasive risk of excessive proceduralism."[30]

However, all too often in the regulatory reform debate the costs of reform are ignored or dismissed as being easily outweighed by the perceived benefits.

> "Analysis in terms of divergences between private and social product concentrates attention on particular deficiencies in the system and tends to nourish the belief that any measure which will remove the deficiency is necessarily desirable. It diverts attention from those other changes in the system which are inevitably associated with the corrective measure, changes which may well produce more harm than the original deficiency."[31]

There exists a strong case for paying greater attention to the costs, both direct and indirect, of any reform proposals.[32]

What are regulatory costs?

When referring to regulatory "costs" there is an implicit recognition of the many and varied ways in which regulations can impact on economic decisions. In addition to the obvious, direct costs such as the financial cost of preparing due diligence reports, there are also less tangible costs that flow from legal uncertainty.

We can divide regulatory costs into a number of categories, including "opportunity costs", "transaction costs", "compliance costs" and "public resource costs". The generic costs associated with regulations are many and varied. Some of the more obvious costs for businesses include the paper burden or administrative burden from complying and reporting on particular requirements, complying with standards, licence fees and other charges levied by governments, charges likely to be required in

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[28] V Goldwasser, op cit n 6 at 479.

[29] CLERP Financial Markets, op cit n 1, p 27.

[30] C Sunstein, "The Cost-Benefit State" (Chicago Working Papers in Law and Economics (Second Series), University of Chicago, May 1996) p 5. Some regulatory agencies have raised legitimate concerns that the Regulatory Impact Statements may not be cost-effective: Office of Regulation Review, Industry Commission, *Regulation and its Review: 1996-97* (1997) ("ORR Review"), p 30 Box 2.2.

[31] R Coase, "The Problem of Social Cost" (1960) 3 *Journal of Law and Economics* 1 at 42-43; cf. S Schwab, "Coase's Twin Towers: The Relation Between *The Nature of The Firm* and *The Problem of Social Costs*" (1993) *Journal of Corporation Law* 395 at 367-369; for a direct application of the Coase theorem to security market regulation see J Mulherin and J Netter, "Prices Are Property: The Organisation of Financial Exchanges from a Transaction Cost Perspective" (1991) 34 *Journal of Law and Economics* 591.

[32] R Coase, op cit n 31 at 42-43; B Niskanen, "The Total Cost of Regulation" (1991) 14(3) *Regulation* 23; T Hopkins, "The Costs of Federal Regulation" (1992) 2 *Journal of Regulation and Social Costs* 5; Anon, "Overregulating America: Tomorrow's Economic Argument", *The Economist* 2 August 1996, p 17; C Sunstein, op cit n 30.

production, transportation and marketing procedures, shifts to alternative sources of supply and delays to the introduction of goods into the marketplace or, alternatively, restrictions in product availability.[33]

In the realm of taxation law, the compliance costs and transaction costs of regulations have been specified so as to include:

> "[T]he external costs of professional advisers hired to deal with the tax and the time costs of internal staff spent in collecting and maintaining tax information, completing forms, preparing information and dealing with the Tax Office. Planning costs, which are the costs of examining the implications of a transaction and choosing a method to minimse the taxed involved are an important form of compliance costs, especially for businesses which have to pay company tax."[34]

Consumers will be adversely affected by regulations to the extent that they will often pay higher prices for goods and services, face a reduced level of quality and choices, experience delays in the introduction of goods into the marketplace and restrictions in product availability and expensive or complicated redress.[35] There are also costs for government from introducing new regulatory processes or amendments. These costs are a result of the numbers and level of staffing, salary costs, costs of other relevant items such as any special advertising, accommodation and travel and, finally, enforcement costs.[36]

Each additional regulatory requirement arguably adds to the compliance costs for corporations. Governance statements in annual reports, for example, often require input from external advisers and add to the cost of producing and distributing the annual report.[37] As regulation extends beyond parliamentary legislation and may include (a) common law requirements, and (b) the discretions of regulators, regulatory costs can also eminate from from new case law precedents[38] and the actions and approaches employed by the ASIC.[39] For our purposes, any cost, detriment, lost opportunity, or inefficient behaviour that is attributable to securities regulation will be referred to as a "regulatory cost".

If we proceed beyond the general costs of regulations it is possible to focus on the specific costs

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[33] Office of Regulation Review, Industry Commission, *A Guide to Regulation* (1997) ("ORR Guide") B4; ORR Review, op cit n 30; J Soon, "The Economics of Regulation Review" (1996-97) *Policy* 58 at 59.

[34] J Soon, op cit n 33 at 59.

[35] ORR Guide, op cit n 33, B4-B5.

[36] ORR Guide, op cit n 33, B4.

[37] E.g. G Whitread and I Zimmer, *Financial Accounting: Incentive Effects and Economic Consequences* (1992, 3rd ed) p 408 fn 1; Corporate Law Economic Reform Program, *Accounting Standards: Building International Opportunities for Australian Business* (AGPS, CLERP Proposals for Reform: Paper No 1, 1997) pp 16-17; I Lee and S Lochhead, "The Costs of Raising Capital" (1996) *Journal of Financial Research* 59; I Bickerdyke and R Lattimore, "Reducing the Regulatory Burden: Does Firm Size Matter?" (Industry Commission, Staff Research Paper, 1997).

[38] The most emphatic example of this phenomena can be found in relation to directors duties: "… the trend has been for the legal duties bearing on directors to become more onerous. This can be economically costly as directors – who can practically hold a small number of directorships – are less well-placed than shareholders and creditors to diversify risk. In principle, the resulting risk could be partly offset by increasing the insurance and indemnity available to directors… Nevertheless, the cost of securing such insurance, notably when the law remains in flux, suggests that there would be gains from clarifying the range of circumstances in which directors" actions would be legally protected': OECD, op cit n 19, pp 104-105.

[39] 'The Australian Securities and Investment Commission (ASIC) assumes responsibility for market integrity and consumer protection across the financial system, including for investment, insurance and superannuation products': G Stephens (ed), *Reserve Bank of Australia: Bulletin: July 1998* (1998) p 1. Of course, other regulators such as the ACCC and the ATO are also relevant to this point.

associated with securities market regulation. Deregulatory reform advocates would emphasise the effects of securities regulation costs on globalisation and regulatory harmonisation, overseas investor preferences, the reduced number of investment opportunities, and the inability to attain optimal, negotiated outcomes, as well as behavioural implications in the areas of moral hazard, innovation and adaptation. Furthermore, this article will apply fundamental macroeconomic analysis to bring into sharp relief some of the potential side effects of regulatory costs.

The effects of globalisation and harmonisation

A relevant consideration when evaluating market confidence is the harmonisation of securities markets which has resulted from the progressive globalisation and deregulation since the early 1980s. Although research on the dynamic interactions between national security markets is still in its embryonic stage, there is some evidence to suggest that the dominant stock markets - in countries such as the United States and Japan - play an important role in establishing the level of confidence in other national markets: the available evidence yields the conclusion that although stock markets are interdependent, bond market price movements in different markets are not statistically correlated.[40] This is obviously an important consideration for any reform advocates.

> "It is important to recognise Australia is not a major market and cannot dictate terms to the major markets. There are trade-offs to ensure Australia's regulation does not get too far out of step with the rest of the world while maintaining the standards which Australians expect."[41]

Overseas investor preferences

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. This conclusion is too clever by half: overseas investors are also bound by the 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[42] then the performance of the securities acquired by the overseas investors will be similarly affected.

> "[N]o country formulates the content of its securities laws without a good deal of consideration of the practices of its sister countries. A country seeking to contain its companies and investors by a wall of unreasonable regulatory demands will find a fibre optic tunnel through its ramparts allowing its subjects to escape to more hospitable markets."[43]

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[40] A Bhoocha-oom and S Stansell, "A Study of International Financial Market Integration: An Examination of the United States, Hong Kong and Singapore Markets" in S Stansell (ed), *International Financial Market Integration* (1993) p 181: "We found no significant cross correlation between real [interest] rates in the United States and Singapore"; cf. C Eun and S Shim, "International Transmission of Stock Market Movements" in S Stansell (ed), *International Financial Market Integration* (1993) p 273: "Our evidence indicates that a substantial amount of interdependence exists among national stock markets... Moreover, the United States stock market is found to be, by far, the most influential market in the world."; contra. G Dwyer and R Hifer, "Are National Stock Markets Linked?" in S Stansell (ed), *International Financial Market Integration* (1993) p 254: "The level of stock price indexes in different markets need not move closely together: indeed, they do not."

[41] A Shaw and P von Nessen, op cit n 13, p 213.

[42] See n 57, below, and accompanying text.

[43] J Cox, "Foreward" in G Walker et al, op cit n 7, p v; J Cox, "Rethinking US Securities Laws in the Shadow of International Regulatory Competition" (1992) 55 *Law and Contemporary Problems* 157 (Cox suggests that the stringency of US securities laws puts domestic companies at a competitive disadvantage in the international marketplace); cf. A Licht, "Regulatory Arbitrage for Real: International Securities Regulation in a World of Interacting Securities Markets" (1998) 38 *Virginia Journal of International Law* 563.

Moral hazard

Apart from the direct "costs" of securities regulation, there are also behavioural effects which impose costs on society at some time in the future. In this regard there is the rather intangible influence of additional regulatory prescriptions on society's "moral hazard". Stated simply, the imposition of new regulations often creates the impression, in the investor's mind at least, that there is some kind of guarantee against failure and the belief that the government and/or the regulators are to be blamed when things go wrong. The upshot of this may be that governments, in particular, feel pressure to compensate investors when they lose money and that investors will take undue risks, secure in the knowledge that the government will compensate them for any losses.[44] Recent examples of this "moral hazard" include the Victorian government's compensation fund for Tricontinental investors, the US Government's bail-out of the savings and loan industry and the potential for Commonwealth government liability in respect of the compulsory superannuation surcharge.

Reduced investment opportunity set

There is some evidence to suggest that enactment of certain securities regulation has forced "riskier"[45] investments off the market.[46] This may be rationally explained by the fact that securities underwriters are less willing to take risks if they face a greater potential liability. If this is indeed the case, then investors are certainly no better off as they face a reduced set of possible investment opportunities whereas, in all likelihood, they would have merely expected a higher compensation for investing in riskier securities. It may also mean that riskier businesses will have less funds available to finance their new ventures - this is critically important to national economic growth.

Sub-optimal negotiated outcomes and the views of market participants

A major indirect "cost" of any regulation, but one which does not receive much attention, concerns the lost opportunities in relation to innovation and optimally negotiated outcomes. It is argued that regulators should refrain from *prescribing* market outcomes unless it is necessary to do so. Contravening this suggestion can, in many instances, result in sub-optimal outcomes and discourages future, efficient behaviour. The inability to negotiate regulatory outcomes is not ideal for a number of reasons.

By way of example, we will focus on the prospectus provisions of the *Corporations Law.*

> "The regulatory policy underlying the fundraising provisions of the *Corporations Law* is one of disclosure, that is to protect investors by endeavouring to ensure that they are informed fairly about any invitation or offer of securities and given all information relevant and necessary to the making of an informed investment decision."[47]

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[44] See V Goldwasser, op cit n 6 at 475 and sources cited therein.

[45] Riskier in the sense of higher stock return variances (or volatility) rather than risk in the sense of dubious investments promoted by shylocks. It is important to note that "there is no evidence that securities risk is positively correlated with fraud.": R Romano, op cit n 5 at 2393.

[46] J Stigler, "Public Regulation of Securities Markets" (1964) 37 *Journal of Business* 117; G Jarrell, "The Economic Effect of Federal Regulation on the Market for New Securities Issues" (1981) 24 *Journal of Law and Economics* 613. For a more in-depth discussion of this point, see R Romano, op cit n 5 at 2376 – 2377; R Posner and K Scott (eds), *Economics of Corporation Law and Securities Regulation* (1980) Chapter 11 "Assessments of the SEC's Performance".

[47] M Taylor, "Capital Raising in Australia" in G Walker et al, op cit n 7, p 289.

An often pleaded rationale for the existing prospectus provisions is that the costs involved would still be necessary even if the law did not exist, because investors would require the company to undertake a similar exercise before they would be willing to invest in the company.[48] But would they? This proposition raises a number of questions. Wouldn't certain investors require less rigorous disclosure or, indeed, none at all? Where is the equitable rationale for requiring a company to disclose voluminous information to professional investors who can hardly be desribed as vulnerable members of society? The information should be tailored to the needs of the investor and while this may mean, in certain instances, that the costs of disclosing to investors is the same what would be incurred under the current regulations, it may also result in less total cost as some investors require less disclosure or only focus on particular elements of the information currently required to be disclosed. Under the current regulatory framework this option does not exist such that the company and the investor cannot agree to a cost-effective method of prospectus disclosure. Similar comments would apply to the suggestion that the *higher* risk profile of low-disclosing companies will discourage investment in those companies. If the investment funds are not forthcoming then, at that point, the (potential issuer) company has a powerful incentive to provide disclosure and avoid the Mexican stand-off.

It should also be recognised that the nature of much modern commerce represents a "repeat play" environment where transactors must interact with each other on a repetitive basis.

> "Even in a state of nature, given that the parties often face the prospects of repeated interactions with each other, the [transacting on fair terms] problem may solve itself, with recognition emerging over time that co-operation rather than defection is the *joint welfare maximising* strategy…"[49]

Similarly, the argument that it is more cost effective for a company to provide information through prospectus disclosure really side-steps the whole issue of whether regulations should force a company to disclose information which is not necessary, based on the parties' requirements, for the transaction to proceed. The obvious retort to such suggestions is that the loosening of the prospectus provisions will permit abuse of the innocent investor by large, tyrannical company. Two considerations in this regard are, firstly, the increasing relevance of institutional investors[50] who ensure that, to a large extent, publicly available information is incorporated in the company's stock price and who lobby management and directors for governance and operational changes, and, secondly, the ethical and philosophical question of whether equitable rights should be accorded to anyone who is not as powerful as their competitor or whether these rights should only be accorded to the most needy members of society.

In the same vein, regulators would do well to consider the views of market participants. While market participants will rarely, if ever, share a common view on specific matters, they do represent an acceptable proxy for empirical evidence and are often more relevant than theoretical arguments.

> "…no government can know better than market participants what regulations are in their interest, particularly as firms' requirements are continually changing with shifting financial market conditions."[51]

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[48] C Grose, "Will the Small Business Fundraising Reforms Proposed by CLERP Really Make it Easier for SMEs to Raise Capital in Australia?" (1998) 16 *Company & Securities Law Journal* 297 at 307; G Hone, "Fundraisings and Prospectuses – The CLERP Proposals" (1998) 16 *Company and Securities Law Journal* 311 at 322: "will not the negotiations with the issuer, in most cases anyway, lead to the issuer being required to provide information material to the making of an informed investment decision, namely, the information which an investor would reasonably require".

[49] M Trebilcock, "An Introduction to Law and Economics" (1997) 23(1) *Monash University Law Review* 123 at 138.

[50] G P Stapledon, *Institutional Shareholders and Corporate Governance* (1996).

[51] R Romano, op cit n 5 at 2365.

While there are obvious societal goals and third party externalities which need to be taken into account, there is also a compelling argument that the views of market participants (and potential plaintiffs) are deserving of more weight than the views of legal academics and regulators. To date, there has only been a limited number of Australian studies which reflect the views of market participants.[52]

Phrasing the proposition slightly differently, if logic and theorising suggests that a regulatory reform is bad for market participants and yet market participants are vigorously requesting the regulatory reform, regulators would be well advised to consider, at length, the reasons why there is a gap between the theory and the wishes of the market: why are they requesting reforms which will have a deleterious effect? Is there information asymmetry? Are special interests promoting the debate? Should perhaps market participants be given an option as to whether the regulations will come into force?[53] Is the theory founded on premises which are not derived from experience in the market? Do not investors voluntarily place their money into securities?

Impediments to innovation and adaptation

Related to this desire to see more privately negotiated market outcomes is the concern that regulation prevents, or at least hinders, innovation and adaptation.[54] It has been noted that Australia community needs to become more entrepreneurial[55] if it is to increase its living standards on a permanent basis, and that one of "the few specific areas where improvement will be of particular help to company creation and growth are a reduction in compliance costs as regards taxation and regulation and increased intermediating of risk capital."[56]

Macroeconomic detriment

The concern with increasing regulatory costs stems, in large part, from the relationship between companies (and other economic actors) and their interaction with the economy. When we apply elementary tools of economic analysis we will see that increasing regulatory costs may result in lower levels of employment and higher inflation as well as other macroeconomic trade-offs.

Figure 1 represents a neo-classical view of the world. On this chart are two curves: the supply curve

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[52] GP Stapledon, op cit n 50, Part III; I Ramsay, G Stapledon and K Fong, *Institutional Investors' Views on Corporate Governance* (Research Report, Centre for Corporate Law and Securities Regulation, University of Melbourne, 1998); R Tomasic and S Bottomley, *Directing the Top 500* (1993).

[53] The argument that regulations are a form of an option because the targeted plaintiffs have an option to *not* enforce the provisions is not a robust proposition. Firstly, it is often the case that a government agency such as the ASIC will enforce the laws rather than a market participant and the agency will have different incentives and motivations to participants. Secondly, the plaintiffs will have different objectives before and after the potentially illegal event; the desire to maximise societal utility may dissipate once they see an opportunity to capitalise on the existing regulations to their benefit (bearing in mind they are often profit maximisers!). Thirdly, market participants are often required to commence legal action (or a third party will commence legal action on their behalf) even when they can see benefits in not enforcing the regulations, such as when they are covered by an insurance policy. Finally, the mere threat of legal action influences potential defendants by circumscribing their actions to avoid the *threat* of being sued.

[54] D Goddard, "Company Law Reform – Lessons from the New Zealand Experience" (1998) 16 *Company and Securities Law Journal* 236 at 249 n 42: "It is difficult to over-emphasise the importance of choices over time, rather than leaving experts to determine the one "right way to do things". Experimentation is important. Circumstances change."

[55] OECD, *OECD Economic Surveys: 1997-1998: Australia* (1998) p 116: "entrepreneurship can be defined as the dynamic process of identifying economic opportunities and acting upon them by developing, producing and selling goods and services."

[56] Ibid at 13, 126, 144

represents the quantity of goods which producers in the Australian economy are willing to supply at each price level; and the demand curve represents the quantity of goods which consumers are willing to demand at each price level. When the price at which producers are willing to supply goods is equal to the price at which consumers are willing to purchase goods (Eq1) then we say the economy is in equilibrium. At the corresponding equilibrium price of P1 a quantity of Q1 will be demanded and supplied.

FIGURE 1

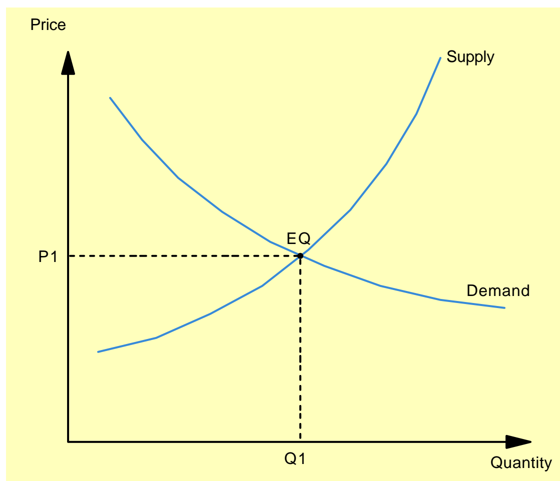
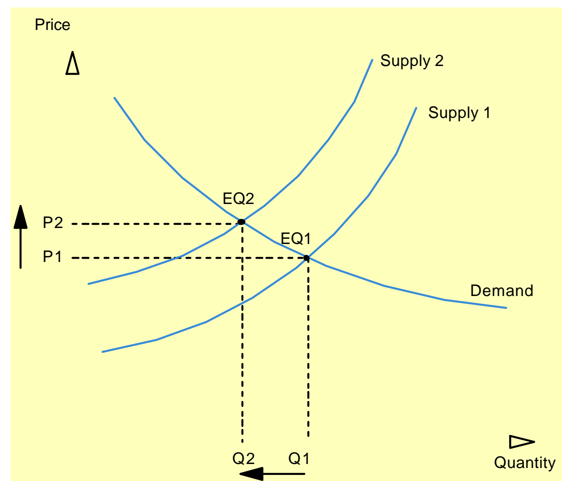


FIGURE 2



Now, assume that the regulatory costs in the Australian economy increase because of the introduction of a new law, regulation or judicial precedent: as illustrated in Figure 2. It is assumed that these regulatory costs, in one way or another, increase the costs of production. Producers, assuming they aim to maximise profits, will respond to this development by supplying less goods and services at each price level. The result being that the new equilibrium (Eq2) results in a new price of P2 and a new level of supply at Q2. The important aspect of this development is that P2 is higher than P1 and Q2 is lower than Q1. In other words, prices have increased while output has decreased. Applying this analysis to the Australian macroeconomy it becomes apparent that an increase in regulatory costs can result in a mild form of stagflation whereby both inflation and unemployment are simultaneously increased.

This analysis has been conducted assuming a simple upwarding sloping supply curve and a downward sloping demand curve but the results would be similar, to differing degrees, with an asumption of perfect competition, monopolistic competition or monopoly market structures.

> "A country's regulatory policies can have a significant impact upon a country's economic performance because of its effects upon incentives to compete and innovate and its bearing upon a firm's production costs. For the latter reason it also determines the attractiveness of a country as a place in which to invest and thus create employment."[57]

To the extent that competitiveness enhancements increase the economy's international competitiveness we would expect to see:

[57] J Soon, op cit n 33 at 63.

1. More exports and less imports;
2. Improved work productivity which will increase the demand for labour without a corresponding increase in prices;[58] and
3. Less onerous regulatory burdens will allow producers (for the reasons identified above) to reduce prices and/or increase output and employment.

In this light, regulatory costs can be seen to play an important part in determining the level of inflation and unemployment in the Australian economy. To the extent that increased regulatory burdens increase regulatory costs, the economy will experience a higher natural rate of unemployment.[59]

Given that an increase in regulatory costs may result in higher inflation, it follows that the change in domestic price levels will reduce the competitiveness of Australian exports and import competing industries which will have ramifications for the Australian trade balance.

From an international competitiveness perspective, regulatory costs are an important issue but one which has not received enough attention to date.

> "Because of increased global competition faced by Australia to attract investment as well as its effects on the international competitiveness of firms already operating here it is a good strategy to keep such production costs down as much as possible."[60]

As well as the possible effects on Australia's trade balance, there are also implications for the capital account which measures foreign investment in Australia.

> "The costs associated with rulemaking will be an important parameter of international competitiveness, as regulatory machinery that imposes comparatively high costs will tend to delay the introduction of new rules allowing the implementation of new technologies or adaptation to the consequences of their implementations. Such delays may well cause the diversion of business to a more agile investment centre."[61]

In summary, 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[62] and the consequential reduction in the competitiveness of Australian companies.[63]

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[58] Conversely, it could be argued on economic-empirical grounds that improved work productivity will reduce the demand for labour as less employees are required to produce the same level of output. To complicate matters even further, the improvement in work productivity will alter the relative cost of labour relative to capital which provides owner/managers with incentives to substitute labour for capital. Econometric analysis is usually employed by economists to determine the net effect of these different economic incentives.

[59] The Natural Rate of Unemployment represents a level of unemployment in an economy which does not correspond to increasing inflation. In other words, if the unemployment rate is reduced there is no corresponding increase in inflation. Once the actual unemployment rate falls below the natural rate of unemployment then economists would expect inflation to increase: J Trevithick, *Inflation: A Guide to the Crisis in Economics* (1980) p 63. The Australian NAIRU is not well defined although it is often thought to be around 6.5% of the workforce: Hon. Justice Ipp and W Weerasooria (eds), *Butterworths Business and Law Dictionary* (1997) p 316.

[60] J Soon, op cit n 33 at 59.

[61] A Simpson, "Securities Regulation for the Information Age" in G Walker et al, op cit n 7, p 48.

[62] ORR Review, op cit n 30.

[63] M Williams-Wynn, *Enhancing Australia's Competitiveness: The Impact of Government Regulations* (Committee for the Economic Development of Australia Report, 1996); Industry Commission, *Implications for Australia of Firms Locating Offshore* (Draft Report, 1996). Referring to the relationship between securities regulations and market confidence, it is possible that changes in the severity of regulations can impact market confidence in an indirect manner. Firstly, an increase in regulatory severity may adversely effect macroeconomic indicators. This negative macroeconomic developments will then, secondly, impact upon market confidence. In

Having examined regulatory costs in the Australian context, the next section in this article will critically review some of the reasons why most nations have adopted securities regulations in one form or another and why those societies have (implicitly) decided to accept the concomitant regulatory costs.

Scrutinising the purported benefits of securities regulations

> "After fifty years, the proponents of regulation have no scientifically acceptable evidence of net benefits for any disclosure rule that rests on reducing fraud or increasing confidence."[64]

The conventional wisdom regarding securities regulation is that they can be justified on the basis that they prevent market fraud and that they ensure equality of opportunity for both current and prospective investors. As such, the benefits of securities regulations are well documented.

> "Regulation exists not only in the interests of investors but also in the interests of enterprises which need to raise capital. Experience shows that when members of the general public are offered an opportunity to invest in an intangible claim there is a need for disclosure by the persons extending the offers. The merits of an intangible claim cannot be assessed by inspection as in the case of land or goods.[65] The need for disclosure is present in the primary market for securities, the market in which capital is raised by the issue of new securities. It also exists in the secondary market in which securities already issued are traded… Experience also shows that the availability of capital for corporate endeavour requires that the investing public should have confidence in the honesty and efficiency of securities markets and of persons carrying on the business of dealing in securities… Securities law is not always restrictive: it facilitates trading in securities."[66]

The objectives of financial system regulation include:[67]

- Market integrity – promoting the efficiency and fairness of capital markets;
- Investor protection – providing financial investors with transparent information, equality of opportunity and the ability to seek recompense for any losses incurred;
- Enhanced competition – facilitating competition between financial service providers; and
- Minimisation of systemic risk – avoiding the situation where the collapse of one major financial player causes the collapse of other financial institutions, which may lead to a dominio effect resulting in the collapse of the entire financial system.

It would be naive to refuse to acknowledge that many regulations provide significant benefits and enable our society to operate in a more efficient, productive and humane manner. Moreover, uncertain

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other words, more stringent regulations could, in the end analysis, have a particularly relevant *negative* impact upon market confidence through macroeconomic linkages.

[64] F Easterbrook and D Fischel, op cit n 82, p 297.

[65] If the 'value' of land or goods is based on the cash flows derived from the tangible asset (S Thompson Jr, "A Lawyer's Guide to Modern Valuation Techniques in Mergers and Acquisitions" (1996) *Journal of Corporation Law* 457; R Brealey and S Myers, *Principles of Corporate Finance* (1991, 4th ed) Chapter 2), query how mere physical inspection will contribute to the evaluation of the investment's merits. Anyone who invested in commercial property in the late 1980s will be aware of the fact that "bricks and mortar" are not by virtue of their tangible nature any less risky than intangible investments such as shares, bonds or derivatives.

[66] R Baxt, HAJ Ford and A Black, *Securities Industry Law* (1996, 5th ed) pp 2-3; M Coco, "Towards Enterprisation: Shareholder Rights and Economic Reform in Russia" (1998) 36 *Virginia Journal of International Law* 169 at 188.

[67] CLERP Financial Markets, op cit n 1, p 26; Commonwealth of Australia, *Financial System Inquiry Final Report* (1997) pp 187 – 190.

laws may require the adopted of more onerous regulations to provide regulatory certainty: legal uncertainty generates inefficiencies of its own "including increased legal and compliance expenses".[68] Legal uncertainty will result in social costs to the extent that businesses and other economic actors require detailed legal opinions before undertaking transactions which may, potentially, contravene the uncertain regulations.[69] While the main lesson to be drawn from this point is the need to resolve legal uncertainty so as to minimise unnecessary regulatory costs, it also illustrates an instance where more regulation may be preferable to less. In addition, it should be acknowledged "that a large part of the burden of compliance relate to activities – accounting and auditing – which the companies would arguably have to undertake even in the absence of regulation and taxation"[70] and that sometimes a reduction in the quantity of legislation may result in higher compliance costs.[71]

There are several examples where government regulation can reduce transaction costs. It is generally accepted, for example, that Table A in the Corporations Law provided a cost effective method of establishing default corporate constitution terms and conditions.[72] The voluntary adoption of Table A by many smaller companies is proof enough of this point. In the realm of utility regulation, regulations can be shown to improve social welfare by promoting market certainty and the recognition of regulatory costs in the bargaining environment between those seeking to access the utility infrastructure and those who are providing access.[73]

Notwithstanding these numerous and, often, significant benefits, there are still instances when the alleged benefits of securities regulations do not withstand serious scrutiny. It is proposed to examine two of those instances. Firstly, there is a popular defensive argument that stringent securities regulations are cost justified because adopting cost effective regulations would involve a down-ward spiral towards laissez faire economics. This proposition will be critiqued based, in part, on similar concerns which have been expressed in relation to the Corporations Law. Secondly, the (often implicit) assumption that more stringent securities regulations promote market confidence is contrasted with the empirical evidence from a study of New Zealand regulatory reform.

International regulatory competition concerns

For some time now, there has been growing concern that globalisation and overemphasis of regulatory costs will result in a "race to the bottom" where competing jurisdictions commence a downward spiral of de-regulatory "loosening" of regulatory standards to the detriment of investors and borrowers.[74]

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[68] M Hains, "Derivatives Regulation in Australia" in G Walker et al, op cit n 7, p 665.

[69] It is often the case that uncertainty regarding the application of law will result in the assumption that the law *is* applicable to the relevant situation: e.g. C Mulholland and A Lester, "Regulation of Derivatives in New Zealand" in G Walker et al, op cit n 7, p 727: "The doubts which have arisen in the past as to the capacity of certain entities to enter into derivatives has limited the involvement of such entities in the derivatives market in New Zealand, and as such could be argued to have been another form of indirect regulation."

[70] OECD, op cit n 19, p 128.

[71] R Pitchford, "An Economic Analysis of Australian Damage Remedies for Misleading Prospectuses: Trade Practices Act versus Corporations Law" (1998) 31 *Australian Economic Review* 27.

[72] D Goddard, op cit n 54 at 252. *Company Law Review Act 1998* (Cth.) abolished the need for a company to have a memorandum of understanding and replaced Table A with a regime of "replaceable rules" (see also s. 1362CC *Corporations Law*; H Ford, R Austin and I Ramsay, *Ford's Principles of Corporations Law* (1999, 9th ed.) p 175).

[73] J Gans and P Williams, "A Primer on Access Regulation and Investment" in Australian Competition and Consumer Commission and the Public Utility Research Centre at the University of Florida (eds), *Infrastructure Regulation and Market Reform: Principles and Practice* (1998) p 150.

[74] V Goldwasser, op cit n 6; R Romano, op cit n 5; A Licht, op cit n 43.

This theory is also referred to as "international regulatory competition": "financial business is necessarily attracted to the provision of the most economically efficient laws and legal environment."[75]

> "… the Australian markets are part of a global trading environment characterised by cross-border capital flows and institutional investors which operate across international markets. Therefore, Australia cannot reform its market regulation in isolation from other jurisdictions and international developments."[76]

It is important to draw attention to the fact that, as an empirical matter, similar concerns have not been realised in the realm of corporate regulation.[77] More importantly, investors will impose a "risk premium" on investments issued or traded in an environment where those investors are not adequately protected from market manipulation. The investors charge a higher premium for two types of regulations: those which impose excessive burdens in the form of regulatory and opportunity costs, and those which do not adequately protect investors from unscrupulous market behaviour. This risk premium will only be minimised when investors consider that the regulatory environment provides an optimal balance between investor protection and cost efficiency.[78] Any issuer who does not heed this warning will experience higher costs for raising debt or equity.

In addition, assuming investors have some influence over regulatory developments or, alternatively, assuming that they can choose the jurisdiction in which they conduct their transactions, then the rules would be more closely aligned with the preferences of investors. Given that investors' decisions drive the prices observed in the capital markets, this would be a positive development in regulatory policy. As a result, the market participants will contribute to the appropriate balance of regulations and this balance will be enhanced by competing regulations in different jurisdictions. Accordingly, the concerns over the "race to the bottom" seem, in the absence of additional empirical evidence, to be currently overstated.

Nevertheless, a (perhaps unintended) side effect of globalisation and market integration is the movement towards greater harmonisation of security market rules and the reduction of barriers.[79] This development will influence, and indeed constrain, the recommendations of law reform bodies and the actions taken by governments and regulators. However, we also need to avoid the dangers of adopting overseas regulations *merely* to promote the objective of international regulatory harmonisation.

> "No doubt there would be significant advantages in convenience to companies and investors if rules were harmonised, and such rules should make it easier for countries to accept foreign financial actors. Nevertheless, there is no assurance that harmonised rules would avoid financial disasters, prevent fraud or other securities misconduct. Securities violators have

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[75] V Goldwasser, op cit n 6 at 483.

[76] CLERP Financial Markets, op cit n 1, p 31.

[77] R Romano, op cit n 5 at 2388 - 2392; R Romano, *The Genius of American Corporate Law* (1993).

[78] R Romano, op cit n 5 at 2366 – 2367: "Promoters thus will bear the cost of operating under a legal regime inimical to investor interests, and they will therefore select the regime that maximises the joint welfare of promoters and investors… The entrepreneurial motivation to reduce capital costs that operate in a competitive legal system mitigates the otherwise core problem for a government regulator of identifying what regulation will benefit investors in capital markets."

[79] A Aburachis, "International Financial Markets Integration: An Overview" in S Stansell (ed), *International Financial Market Integration* (1993) p 26: "by the late 1980s the markets of the major industrialised nations had moved towards fuller integration. For the global finance service industry these changes have led to greater harmonisation of rules and the reduction of barriers, which will allow for the free flow of capital and permit all financial firms to compete in all markets." A more circumspect perspective on the impact of globalisation would suggest that "cultural factors, local competitive advantages and the costs of operation internationally" will constrain the influence of globalisation on regulatory policy: V Goldwasser, op cit n 6 at 472.

> shown that they are adept at avoiding most regulations. Furthermore, there is the concern that rules may carry additional costs, making markets more expensive and perhaps less efficient."[80]

While international regulatory harmonisation and convergence may, at first glance, be seen to promote the objectives of reducing regulatory compliance costs, a case-by-case assessment will be needed to determine whether the proposed changes will in fact result in a net reduction in regulatory costs.

The relationship between market confidence and securities regulation

It is arguable that the alleged benefits of regulations are often taken for granted without being conclusively demonstrated. In this respect, it is crucial that those benefits are held up to scrutiny and, whenever possible, quantified. In this section of the review, we will examine one of the most prevalent assumptions in securities regulations, namely, that more stringent regulations improve market confidence and thereby improve stock prices. A recent empirical study has concluded that the purported benefits may be more illusory than real and that a more effective way for improving market confidence is to improve economic performance (see statistical results presented in Appendix A).[81] In this regard, and as discussed below, lower transaction costs (through, for example, less stringent securities regulation) may be more effectual in improving market confidence through its effect on economic growth.

In the current debate on regulatory reform, there have been repeated calls for more stringent corporate laws on the grounds that such laws will improve securities market confidence. This review article adopts a different perspective, namely, that securities market regulation has an indifferent effect on the confidence of securities market participants. It will also be suggested that the prevalence of "armchair empiricism" has biased the current debate on securities market regulation.

One of the many contentions of the advocates of further securities market regulation is the claim that tougher insider trading laws and more exacting directors' duties will boost stock prices and, indirectly, strengthen economic growth. Consequently, this article will focus on the particular regulatory issues of insider trading and directors' duties[82] and on a New Zealand study which will be used to draw some implications for the Australian regulatory context.[83]

In gauging the general attitude of those commentators who would advocate more stringent securities regulation, we will refer to the views of Brian Gaynor (as expressed in the first edition of *Securities*

[80] V Goldwasser, op cit n 6 at 475; R Romano, op cit n 5 at 2364.

[81] J Lawrence, op cit n 18.

[82] This paper will only consider legislative regulation as the objective measurement of case law developments is relatively more complicated and indeterminate. Which is not to infer that legislative case studies are straighforward: "Studies of the effects of legislation are hard to carry off, because even inefficient markets impound a great deal of information" (F Easterbrook and D Fischel, *The Economic Structure of Corporate Law* (1991) p 314; G Schwert, "Using Financial Data to Measure Effects of Regulation" in R Posner and K Scott, *Economics of Corporation Law and Securities Regulation* (1980) pp 185-191). It should be borne in mind, however, that legislation is only one form of regulation; the other major forms of regulation being case law and custom. For a successful analysis of the effect of case law developments on share prices, see T Harris and I Ramsay, "Measuring the Effects of Legal Change Using Share Price Data: An Analysis of the Implications of the *Mabo* Decision" (1996) 9 *Corporate & Business Law Journal* 113.

[83] The focus on New Zealand (as opposed to Australia) was a result of the dramatic legal changes in 1988 and 1993 which were expected to have more significance than the piecemeal regulatory changes in Australia over the past decade. In the event that the Australian CLERP reforms are passed into legislation, it would be interesting to examine, from an empirical perspective, the economic effects of such (potentially) dramatic changes. Query, however, whether the effect of any one of the CLERP changes could be separated from the aggregate effect of the other CLERP changes.

Regulation in Australia and New Zealand[84]) who attributes the relatively poor performance of the New Zealand stock market during 1987-1994[85] to low retail investor confidence in the securities markets.

A further strand of arguments in favour of additional security market regulation is provided by Peter McKenzie,[86] the former chairman of the New Zealand Securities Commission, who adopts the view that the severity of New Zealand's 1987 stock market crash and the subsequent underperformance by that market caused by the overheating of the stockmarket prior to 1987, is partly attributable to regulatory deficiencies. In particular, he cites a lack of effective insider trading regulation and the need to revamp the New Zealand Companies Act in respect of directors' duties. The advocates of these views will be referred to as the "regulationists".

In applying the views of the "deregulationists", that is, commentators who see merit in less stringent securities regulation, we will refer to the work of Bryce Wilkinson and Amnon Mandelbaum.[87] They submit that the New Zealand market has not underperformed relative to other international markets since 1987. They also make the observation that if New Zealand's stock market has under-performed since 1987, and this underperformance was due to regulatory deficiencies, why is it that the New Zealand market was able to outperform most of the other world stock markets prior to 1987, during which time the same set of regulations were in force? Wilkinson & Mandelbaum see the fundamental factors affecting share market performance as being:

(a) market volatility;

(b) gearing;

(c) property prices;

(d) economic activity;

(e) interest rates;

(f) market liquidity;

(g) taxation; and

(h) political uncertainty.

For ease of exposition, we shall subsume their factors under the rubric of a "macroeconomic approach" to the determinants of market confidence.

In addition to these macroeconomic considerations, there are other philosophical arguments in favour of the de-regulatory approach. Duggan, Bryan and Hanks provide a concise overview of the arguments against further insider trading regulation:

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[84] B Gaynor, "Securities Regulation in New Zealand: Crisis and Reform" in G Walker and B Fisse (eds), op cit n 13, p 10; see also M Zieglaar, "Insider Trading in Australia" in G Walker et al, op cit n 7, Chapter 16; M Zieglaar, "Insider Trading in Australia" in G Walker and B Fisse (eds), op cit n 13, Chapter 27.

[85] It is perhaps worth questioning whether New Zealand has in fact performed so poorly by relative international standards over that time frame: B Wilkinson and A Mandelbaum, "The Takeover Debate in the Context of Securities Regulation in New Zealand: A Law and Economics Perspective" in G Walker and B Fisse (eds), op cit n 13, p 789.

[86] P McKenzie, "Reforming Securities Regulation in New Zealand" in G Walker and B Fisse (eds), op cit n 13, p 35.

[87] B Wilkinson and A Mandelbaum, "The Takeover Debate in the Context of Securities Regulation in New Zealand: A Law and Economics Perspective" in G Walker and B Fisse (eds), op cit n 13, p 783. In comparing different forms of insider trading regulation reference may also be made to the work of Professor Cox: J Cox, "An Economic and American Perspective of Insider-Trading Regulation in Australia and New Zealand" in G Walker and B Fisse (eds), op cit n 13, p 621.

> "What is so special about securities transactions as to warrant a blanket prohibition on the use of superior (inside) information for trading purposes? The most common response to this question is the assertion that regulation is necessary because the prevalence of insider trading damages investor confidence in the stock market. However, there is no empirical evidence to support this claim. Nor is there any evidence to suggest that the enactment of legislation has brought new investors into the market who had previously been frightened off by concerns about insider trading. On the contrary, at least one study concludes that uninformed investors rely on patterns of insider trading activity as a basis for their own investment decisions. If this is true, the presence of insiders in the market-place may actually serve to stimulate confidence. Furthermore, in countries where there are no effective insider trading laws, such as Japan, there is no evidence of any crisis of confidence in the market... A further consideration is that small investors who are nervous about playing the game because of their informational disadvantages need not withdraw. They can continue to play by investing in diversified mutual funds, and the growth in institutional investment suggests that there may be a trend in this direction."[88]

Furthermore, the anecdotal evidence in terms of the most frequently cited determinants of stock prices by market participants include economic growth, interest rates, unemployment rates, inflation and foreign trade balances.[89] Moreover, many investors make their trading decisions without any regard to public information whatsoever. These investors rely on methods of analysis referred to as technical indicators and charting.[90]

In summary, the regulationists adopt the view that market confidence is determined by the level and content of regulations. The macroeconomic approach, on the other hand, considered that macroeconomic factors were of far greater importance in establishing market confidence.

This article will refer to a study which invokes a simple econometric model[91] to take account of both of these factors. The focus of this research is the insider trading regulations and directors' duties legislation in New Zealand.

The study under consideration[92] examined movements in macroeconomic variables in New Zealand from June 1986 to March 1995. The macroeconomic variables employed in this model were economic growth, inflation and unemployment. The study also examined interest rates consisting of (a) the nominal New Zealand Prime Commercial Bill 90 day spot interest rate; (b) the nominal New Zealand Treasury Bond 10 year spot interest rate; (c) the real[93] New Zealand Prime Commercial Bill 90 day spot interest rate; and (d) the real New Zealand Treasury Bond 10 year spot interest rate.

The statistical study revealed that real interest rates, unlike nominal interest rates, have a significant negative impact on stock prices. The initial analysis also verified a common perception that real

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[88] A Duggan, M Bryan and F Hanks, *Contractual Non-Disclosure: An Applied Study in Modern Contract Theory* (1994) p 182.

[89] R Webb, *Macroeconomic Information and Financial Trading* (1994) Chapter 7 "The Reaction of Speculative Prices to Macroeconomic Information".

[90] J Murphy, *Technical Analysis of Futures Markets: A Comprehensive Guide to Trading Methods and Applications* (1986), Chapter 1 "Philosophy of Technical Analysis".

[91] "Econometrics, the result of a certain outlook on the role of economics, consists of the application of mathematical statistics to economic data to lend empirical support to the models constructed by mathematical economics and to obtain numerical results": G Tintner, *Methodology of Mathematical Economics and Econometrics* (1968) p 74.

[92] J Lawrence, op cit n 18.

[93] A "real" return denotes a nominal rate of return which exceeds the inflation rate. If reported interest rates are 10% and the inflation rate is 8% then the real interest rate is 2%. "A figure that is calculated by adjusting the rate of return according to changes in inflation": Hon. Justice Ipp and W Weerasooria, op cit n 59, p 379.

interest rates are a significant determinant of stock price movements.[94] In the context of a debate as to whether macroeconomic factors or regulatory factors are more important for establishing market confidence, it should be noted that real interest rates are a component of the macroeconomic data.

The analysis was also adjusted to reflect the fact that, in many instances , the stock market can anticipate the release of macroeconomic news based upon other information which is already in the marketplace. For example, movements in aggregate wages, money supply and exchange rates give the markets an idea of future inflation rates (these economic variables are often referred to as “leading indicators” of future economic activity).[95]

Assuming that the New Zealand stock market is at least semi-efficient,[96] then the market will only react to the actual release of the inflation statistics some months later *if* the official statistics differ greatly from the results anticipated by the market participants based on the leading indicators.[97]

The level of market confidence was measured by movements in the New Zealand Capital Index.[98] While it is debatable whether stock price indices are an appropriate proxy for market confidence, the debate over the appropriate level of security market regulation has been conducted on the basis that stock market prices are an objective manifestation of stock market confidence.[99] The effect of securities regulations was measured by the introduction of New Zealand’s insider trading laws and the new directors’ duties laws; as embodied in the *Securities Amendment Act 1988* (NZ) and the *Companies Act 1993* (NZ), respectively.

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[94] W Thorbecke, “On Stock Market Returns and Monetary Policy” (1997) 52 *Journal of Finance* 635 at 651.

[95] For example, in the United States, “[w]hile both the PPI [producer price inflation] and CPI [consumer price inflation] releases affect the markets, the impact of the PPI is consistently greater. We suspect that this is because it is released a week prior to the CPI so that the CPI change is partially predictable based on knowledge of the PPI”: L Ederington and J Lee, “The Impact of Macroeconomic News on Financial Markets” (1996) 9 *Journal of Applied Corporate Finance* 41 at 42; J Hamilton and G Perez-Quiros, “What Do The Leading Indicators Lead?” (1996) 69 *Journal of Business* 27. This theory is confirmed by the correlation coefficients which indicate that economic growth, inflation and unemployment data – all brought forward one period - have a statistically more significant impact on stock prices than current period economic growth, inflation and unemployment, respectively: J Lawrence, op cit n 18, Table 2.

[96] E Fama, “Efficient Capital Markets: A Review of Theory and Empirical Work” (1970) 25 *Journal of Finance* 383; E Fama, “Efficient Capital Markets II” (1991) 46 *Journal of Finance* 1575 at 1589-1599; Fama defines semi-strong form efficiency as a situation where all *publicly* available information is fully reflected in a share’s current market price. There is evidence that New Zealand’s market is semi-strong form efficient: S Swallow, G Walker and M Fox, “The New Zealand Stock Exchange and Securities Markets in New Zealand” in G Walker et al, op cit n 7, Chapter 7.

[97] The theoretical justification for such an approach can also be found in Arbitrage Pricing Theory which stipulates that share prices react to *unanticipated* information disclosure: S Ross, “The Arbitrage Theory of Capital Asset Pricing” (1976) *Journal of Economic Theory* 341; N Lilley, “The Reaction of Australian Interest Rate Markets to the Release of Economic News” (1996) 1(2) *Journal of Applied Finance and Investment* 84; F Campbell and E Lewis, “Here is the News: Now, What Happens to Yields in Australia?” (1998) (Summer, Issue 4) *JASSA* 7.

[98] This index records movements in the major New Zealand stocks. In more precise terms, it is a capitalisation weighted index of the largest and most liquid companies listed on the New Zealand Stock Exchange.

[99] The present author is of the view that volume and liquidity are more meaningful indicia of market confidence. Market participants who have confidence in the market structure but who anticipate a decline in prices will sell shares or futures or buy (sell) put (call) options; to name but a few possible trading strategies. These investors have enough confidence in the market that they are willing to purchase security instruments even though their actions contribute to the lower prices. If the volume of transaction increases while price declines this indicates that market participants have confidence in the market in that they anticipate that they will be able to exit their position at some time in the future. Cf. D Clyman, C Allen and R Jaycobs, “Liquidity Without Volume” (1997) 17 *Journal of Futures Markets* 247. Nevertheless, the regulatory debate has tended to equate stock prices with market confidence.

The first relevant conclusion from the study is that macroeconomic variables do have a positive, robust and significant influence on stock prices (see Appendix A).[100] On the other hand, the regulatory variables did not exert a significant statistical influence on stock prices nor did they have a substantial effect in economic terms. The statistical results provide support for the proposition that there is no relationship between the presence of the relevant legislation and stock prices.

A degree of comfort that these statistical conclusions reflect economic reality, can be taken from a cursory examination of the movements in New Zealand Stock Prices and economic growth over a long time period in both Australia and New Zealand (see Figure 3).

Figure 3

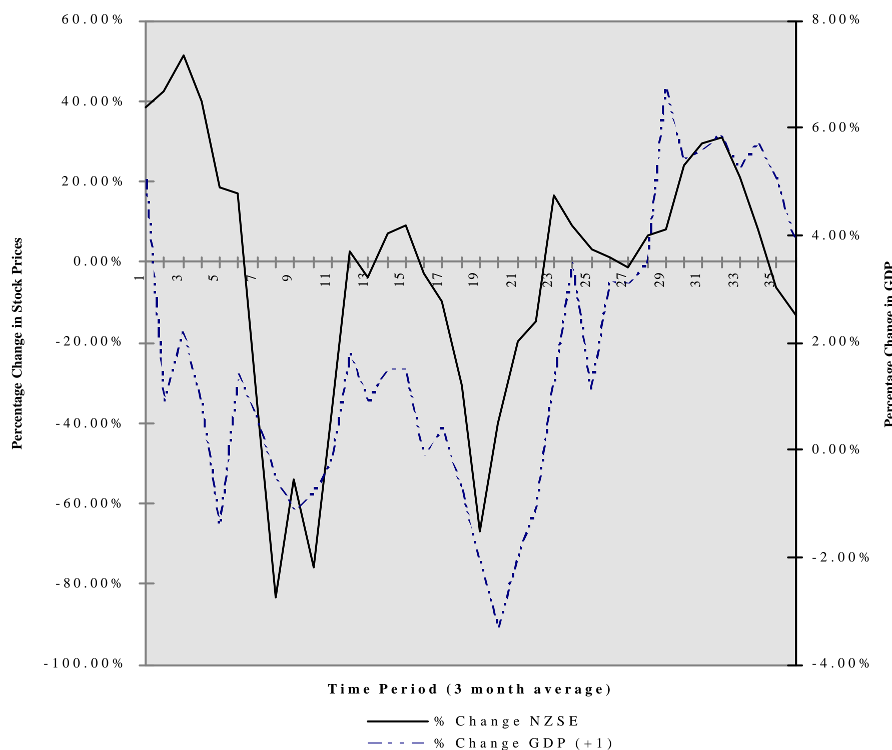

Figure 3 contains data on the broad movements in the prices of New Zealand stocks between June 1986 and March 1995. It also contains the changes in New Zealand's economic growth (as measured by gross domestic product) over the same period, with the modification that the changes in GDP are brought forward one time period (i.e. three months). Aligning these economic variables in the manner discussed results in a set of data points which are closely correlated. A possible interpretation of that data is that past changes in economic growth have a significant impact upon present stock market

[100] This study followed the approach of using the term "significant" to refer to *statistical* results whereas "substantial" is a reference to the *economic* effect of the variable: D Gujurati, *Basic Econometrics* (1995, 3rd ed) pp 133-134. As an example, if the correlation coefficient between the price of personal computers and the number of computer sales exceeds 0.20 then we say there is a significant relationship between computer prices and computer sales. If, however, the regression model yields the result that a 10% decrease in computer prices increases computer sales by only 1% then we might conclude that there is no economically substantial effect of prices on sales. When the results are significant but not substantial it means that one variable does, in fact, have a causative effect on another variable (in a statistical sense) but the consequences of that effect are so minor that it might as well be ignored (in an economic sense).

prices. This provides some anecdotal support for the view that stock prices are substantially affected by macroeconomic growth.

A reasonable conclusion from the evidence provided (particularly the empirical evidence) is that the introduction of the *Securities Amendment Act 1988* (NZ) and the *Companies Act 1993* (NZ) did not, and do not have, a discernible influence on stock prices nor, under currently employed definitions, did they positively influence market confidence.[101] This is not entirely surprising as previous empirical studies have also concluded that case law developments do not have a significant effect on either the sample companies and nor do they have a significant effect on the market as a whole.[102]

These research results are also consistent with numerous American studies which have found that macroeconomic variables play a significant role in determining stock prices in the United States. Consider the following.

> "Several of these economic variables were found to be significant in explaining expected stock returns, most notably, industrial production, changes in the risk premium, twists in the yield curve, and, somewhat weakly, measures of unanticipated inflation and changes in expected inflation during periods when these variables were highly volatile... the [real per-capita] consumption variable was never significant. Finally, we examined the impact of an index of oil price changes on asset pricing and found no overall effect."[103]

Obviously not all macroeconomic variables affect market confidence. Although emphasising a different set of macroeconomic variables, and while focussing on the capital markets excluding equity issues, the same message emerges from the empirical research of Ederington and Lee.

> "[A] considerable portion of the changes in interest rates, and somewhat less of the changes in exchange rates, can be attributed to scheduled macroeconomic announcements - the most important of which are the employment report, [producer price inflation], and the CPI."[104]

[101] The forgoing conclusions and inferences were qualified by some statistical complexities and ambiguities which did not influence the final conclusion. The purpose of the study, however, was not to prove once and for all that economic growth is the dominant factor behind stock prices, rather the study had sought to shine a flicker of econometric light into the dark recesses of the "armchair empiricism" that has captivated the regulatory debate and to demonstrate the way in which some of the prevailing assumptions do not stand up to robust examination.

[102] e.g. T Harris and I Ramsay, op cit n 82; E Weiss and L White, "Of Econometrics and Indeterminacy: A Study of Investors' Reaction to 'Changes' in Corporate Law" (1987) 75 *California Law Review* 551; cf. K Schipper and R Thompson, "Disentangling Interrelated Effects of Regulatory Changes on Shareholder Wealth" (1987) 30 *Journal of Law and Economics* 67; M Beneish, "The Effect of Regulatory Changes in the Airline Industry on Shareholders' Wealth" (1991) 34 *Journal of Law and Economics* 395.

[103] N Chen, R Roll and S Ross, "Economic Forces and the Stock Market" (1986) 59 *Journal of Business* 383 at 402; R LaPorta, et al, op cit n 16; Cf. A Singh, "Pension Reform, The Stock Market, Capital Formation and Economic Growth: A Critical Commentary On The World Bank's Proposals" (1996) 49 *International Social Security Review* 21.

[104] L Ederington and J Lee, op cit n 95 at 49. See also, L Ederington and J Lee, "How Markets Process Information: News Releases and Volatility" (1993) 48 *Journal of Finance* 1161; L Ederington and J Lee, "The Response of the Dollar/Yen Exchange Rate to Economic Announcements" (1994) 1 *Financial Engineering and the Japanese Markets* 111; L Ederington and J Lee, "The Creation and Resolution of Market Uncertainty: The Impact of News Releases on Implied Volatility" (Working Paper, Centre for Financial Studies, University of Okalahoma, 1995); N Lilley, op cit n 97 (Lilley concludes that larger than expected current account announcements and larger than expected inflation announcements lead to a significant increase in the bond rate).

Moreover, there is multi-national research which highlights the pervasive impact of macroeconomic developments (in this case, the exchange rate and industrial structure) in explaining stock prices.[105] Regulatory policy and legislative decrees do not warrant a mention in any of these studies.[106]

An important qualification to these conclusions relates to the manner in which market participants define a "regulation". This article has focussed on the presence or absence of a set of rules prescribing conduct in respect of insider trading and directors' duties. It may be the case, however, that insider trading laws are more important to market confidence in terms of their enforcement and their perceived effectiveness.[107] That is, investor confidence may be influenced by the perceived level of enforcement and the deterrence of insider trading by the securities regulators. The importance of this caveat is reduced by the fact that, notwithstanding the practical importance of such a theory, the current debate has proceeded on the basis that the existence of appropriate regulation is all important.[108] Furthermore, if investor confidence is determined by enforcement and deterrence considerations then the onus shifts to the advocates of further regulation to demonstrate that not only are the regulations desirable in and of themselves, but also that the regulations can be efficiently enforced once they have been written into the statute books.

It must be emphasised that this research does not indicate whether regulatory change is relevant to the wider economy.[109] The confidence of market participants, and therefore market prices, is based on individuals' views of how events, including economic and regulatory developments, will affect the economy. These views will not always accord with economic reality.[110] Nevertheless, to the extent that speculative prices reflect consensus expectations of market participants, it must be acknowledged that securities markets (as the aggregate of the views of individual market participants) place little weight on the regulatory structures under consideration.

It is recognised, of course, that there are various non-economic considerations which enter into the debate on insider trading regulation[111] and this article does not aspire to examine all of views expressed in favour of, for example, insider trading laws.

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[105] R Roll, "Industrial Structure and the Comparative Behaviour of International Stock Market Indices" (1992) 47 *Journal of Finance* 3.

[106] R Roll, "The International Crash of October 1987" (1988) 44 *Financial Analysts Journal* 19 at 31: "none of the institutional market characteristics [were] associated with an unusually large or small October [1987] return after the worldwide market movements were taken into account. In other words, the magnitude of each market's decline was explained by that market's ordinary relation with world market events. Nothing was left to be explained by the particular institutional arrangements in place."; R Roll, "Price Volatility, International Market Links and their Implications for Regulatory Policies" (1989) 2 *Journal of Financial Services Research* 113.

[107] S Vorreiter, "The Prosecution of Insiders" (1992) 4 *Corporate & Business Law Journal* 51; W Hogan, "Insider Trading" (1988) 6 *Company & Securities Law Journal* 39 at 42; R LaPorta, F Lopez de-Silanes, A Shleifer and R Vishny, "Law and Finance" (Working Paper No. 1768, Harvard Institute of Economic Research, June 1996); R LaPorta, F Lopez de-Silanes, A Shleifer and R Vishny, op cit n 16.

[108] Cf. M Zieglaar, op cit n 84 at 593-594.

[109] On the relationship between developed financial markets and investment and economic growth, see R King and R Levine, "Finance and Growth: Schumpeter may be Right" (1993) 108 *Quarterly Journal of Economics* 717; R Levine, "Financial Development and Economic Growth: Views and Agenda" (1997) 35 *Journal of Economic Literature* 688 at 688-689: "the preponderance of theoretical reasoning and empirical evidence suggests a positive, first-order relationship between financial development and economic growth… There is even evidence that the level of financial development is a good predictor of future rates of economic growth, capital accumulation, and technological change"; R Rajan and L Zingales, "Financial Dependence and Growth" (Working Paper No.5758, National Bureau of Economic Research, 1996); R Lucas, "On the Mechanics of Economic Development" (1988) 22 *Journal of Monetary Economics* 3.

[110] R Webb, op cit n 89, pp 267-269.

[111] J Mannolini, "Insider Trading - The Need for Conceptual Clarity" (1996) 14 *Company & Securities Law Journal* 151; M Whincop, "Towards a Property Rights and Market Microstructural Theory of Insider Trading

> "In short, many factors contribute to market volatility and investor confidence... The case for further regulation in response to a fall in market prices and investor confidence is as empty as the counter-argument that a rise in confidence demonstrates the need for less regulation. The case for further or less regulation must be made on cost-benefit grounds regardless of whether market confidence and share prices are high, low, or in between."[112]

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 very 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.[113] This article submits that the current preoccupation with legislative solutions for economic problems (such as more stringent regulations to improve market confidence) is fundamentally flawed and only serves to increase compliance costs for the community and reduces the competitiveness of Australian companies.

The empirical void: How extensive are regulatory costs?

> "A theory that cannot be implemented effectively cannot serve as the basis for public policy."[114]

The increasing recognition of regulatory costs is perhaps demonstrated by a number of recent reviews conducted by different areas within the Federal Government.[115] The two most notable reviews which have prompted a great deal of the public awareness of regulatory costs are, firstly, the Office of Regulation Review (which is a division within the Productivity Commission) and, secondly, the Corporate Law Economic Reform Program.

Office of Regulation review

The Productivity Commission has received a mandate to conduct comprehensive and on-going reviews of Australia's regulatory regime and has, during the course of that review, raised a number of reasons for re-examining Australian regulatory practices.

Regulation - The Case of Primary Securities Market Transactions" (1996) 7 *Journal of Banking Finance Law & Practice* 212; R Tomasic, *Casino Capitalism* (1991); cf. M Whincop, "Precontractual Disclosure by the Insiders of Closely Held Corporations: The Economics of Restrained Self-interest" (1997) 11 *Journal of Contract Law* 177; J Cox, op cit n 87; H Manne, *Insider Trading and the Stock Market* (1966); L Semaan, M Freeman and M Adams, "Is Insider Trading a Necessary Evil for Efficient Markets?: An International Comparative Analysis" (1999) 17 *C&SLJ* 220 at 240: "[insider trading] regulations on the international front have been excessively fuelled by the equity objectives of securities regulations, at the expense of the efficiency objective".

[112] B Wilkinson and A Mandelbaum, op cit n 87, p 794.

[113] E.g. L Ederington and J Lee, op cit n 95; N Chen, R Roll and S Ross, op cit n 103; R Roll, op cit n 106.

[114] R Romano, op cit n 5 at 2381.

[115] Other notable review have been conducted by the Small Business Deregulation Task Force which received the mandate to report on revenue-neutral measures which could be taken to halve the paperwork and compliance burden on small business: Anon, "Deregulation Report Aims at Reducing the Load", *Australian Accountant* 4 December 1996, p 47; and the Wallis Inquiry: Commonwealth of Australia, *Final Report of the Financial System Inquiry* (1997). Finally, the Government passed the *Legislative Instruments Act 1997* (Cth.) which establishes a regime governing standards and procedures for the making, publishing and scrutiny of delegated legislation.

1. Regulations which lack flexibility and which focus on pre-existing problems cannot be readily applied to new situations and scenarios and will not be conducive to technological advances;
2. The ever increasing volume of regulations is often disparate in nature and cannot be consistently and objectively applied by those potentially subject to the regulations; and
3. It is difficult to achieve a reasonable compromise between the perception that Australia is over-regulated and the desire to promote economic and social objectives.[116]

In 1997 the Commonwealth Government took the first steps toward mitigating regulatory costs by imposing a mandatory requirement that all legislative changes include a Regulatory Impact Statement ("RIS") which becomes a component of the explanatory documents which will be tabled before Parliament.[117] Since then a number of developments have taken place:

1. The Assistant Federal Treasurer has been made responsible for regulatory best practice;
2. The Office of Regulation Review was established to report to the Federal Government on compliance with RIS requirements; and
3. The Productivity Commission is to report annually on compliance with RIS requirements.

A significant requirement of the Competition Principles Agreement between the Australian Federal, State and Territory Governments was a comprehensive and systematic review of all legislation which may restrict competition.[118] The Office of Regulation Review has been established to supervise the review's progress until its completion in the year 2000. The Federal Government has extended its own review beyond merely anti-competitive legislation to include any regulatory instruments which imposes costs, or benefits, on business.

The legislative review is guided by the following parameters:

1. Clarify the objectives of the legislation;
2. Identify the nature of the restrictions on competition;
3. Analyse the likely effect of the restriction on competition and on the economy generally;
4. Assess and balance the costs and benefits of the restrictions, and assess whether the objectives of the legislation/regulation can only be achieved by restricting competition; and
5. Consider alternative means for achieving the same result including non-legislative approaches.[119]

Corporate Law Economic Reform Program review

The Commonwealth Treasury has conducted an extensive review of Australia's corporations and securities laws through the Corporate Law Economic Reform Program ("CLERP"). The focus of CLERP's review has been key aspects of business regulation to ensure consistency with the aims of

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[116] ORR Guide, op cit n 33; ORR Review, op cit n 30; R Poole, *Instead of Regulation* (1982); I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate* (1992).

[117] ORR Review, op cit n 30, xii. A Regulatory Impact Statement includes the options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objectives and an assessment of the impact (cost and benefits) on consumers, business, government and the community of each option: ORR Review, op cit n 30, p 7; A Licht, op cit n 43.

[118] ORR Review, op cit n 30, pp 1-3.

[119] ORR Review, op cit n 30, p 4.

promoting a strong and vibrant economy. The policies adopted by CLERP have been developed in consultation with a broad range of individuals and associations in the business and professional communities, as well as the Business Regulation Advisory Group.[120] The CLERP process has admirably focussed attention on regulatory costs and ways of reducing some of those costs.

> "The reforms proposed by the draft provisions are designed to minimise the costs of fundraising while maintaining investor protection… The reforms will promote the operation of informed markets and, by removing unnecessary impediments to fundraising, facilitate investment which is vital to Australia's economic performance. The reforms also seek to ensure that the fundraising rules provide an appropriate cost effective framework for capital raising by small, medium and large companies."[121]

The CLERP proposals, if implemented, will permit small businesses to conduct fundraising with less stringent regulatory compliance requirements (such as raising A$2 million per year from up to 20 persons without issuing any disclosure documentation and allowing a once-off A$5 million fundraising using a simplified prospectus and without requiring full due diligence), reducing the volume of information in prospectuses while simultaneously increasing the volume of information which prospective investors can request from the issuer, removing the prospectus liability overlap in the *Corporations Law* and the *Trade Practices Act 1974* (Cth.), liberalising the advertising provisions, facilitating electronic prospectuses and other ancillary reforms.[122]

And while the CLERP proposals have come under intense criticism from the legal community,[123] such a development should not necessarily be viewed in an entirely critical manner given the different perspectives taken, and philosphies enshrined, within the contrasting legal and business communities in Australia. It should be noted that many of the CLERP proposals relating to fundraising will more closely align the regulation of securities in Australia and the United States.[124] This development is significant as it should mitigate some of the concerns expressed regarding the CLERP approach: some confidence can be taken from the fact that many of the CLERP provisions resemble the positive aspects of the regulatory approach taken in the most liquid capital market in the world.[125] A secondary consideration is that the regulatory convergence between Australia and the United States will have incidental benefits for securities issuers in those two jurisdictions in the form of increased certainty and less complexity. The ability to leverage off United States precedents will probably also yield some benefits to issuers and courts in Australia.[126]

While the Corporate Law Economic Reform Program has advocated a number of significant security regulation reforms, it did not go so far as to undertake a serious reconsideration of security market regulation. For example, it did not comprehensively question the assumption that stringent regulations

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[120] The Business Regulation Advisory Group consists of representatives from the Australian Institute of Company Directors, the Business Council of Australia, the Australian Investment Managers' Association, the Australian Chamber of Commerce and Industry, the Small Business Coalition, the Australian Stock Exchange, the Sydney Futures Exchange and the Australian Corporate Lawyers Association.

[121] Department of the Treasury, *Corporate Law Economic Reform Program: Commentary on Draft Provisions* (1998) p 3.

[122] Ibid at 1-34; Department of the Treasury, *Corporate Law Economic Reform Program: Draft Legislative Provisions* (1998) pp 1 - 94.

[123] E.g. C Grose, op cit n 48.

[124] E.g. *Securities Act 1933* (US) Regulation A (information statement for issue of US$5million or less).

[125] Although this is not proof in and of itself that the regulations are efficient. See n 80, above, and accompanying text.

[126] The Australian Courts are becoming increasingly conversant with United States precedents: G Davies and M Cowen, "The Persuasive Force of the Decisions of the United States Courts in Australia" (1996-97) 15 *Australian Bar Review* 51.

improve market confidence. As a result, there is still plenty of scope for security regulation review and reform in respect of the assumptions underpinning the current regulatory framework. The influence of overseas markets on Australian security market development, the trend towards the harmonisation of international security market rules and the reduction of market barriers, the role of relative economic growth, and the causal relationship between market development and investor protection deserve serious reconsideration in the near future with the ultimate objective being comprehensive legislative reform of Australia's securities regulation.

Law and economics without empirics?

These reviews by ORG and CLERP have provided a central focal point for the issue of regulatory costs. However, the reviews were unable to refer to a comprehensive body of empirical evidence to support or refute their preferred regulatory reforms. A central concern of deregulatory reformers is the lack of reliable empirical research in the public policy debate and the consequential reliance upon anecdotal evidence to fill the void.[127] Recent empirical research indicates that the costs of regulation may be greatly underestimated[128] and as a result, there is a prima facie case for greater attention being paid to the costs, both direct and indirect, of the existing securities regulations and of any reform proposals.

Although a generalisation, there is a growing perception that legal academics (and students) have a propensity to search for ways in which the law can be bolstered to improve the rights of future and potential plaintiffs; whether they be shareholders, beneficiaries, tortfeasors or victims of unconscionability. This article has sought to provide some perspective on the possible detriment which may flow from a never ending process of bolstering laws in such a way as to enhance the rights of those plaintiffs. If we accept that culture is learned from an individual's surroundings and influences,[129] then it is mildly disconcerting that there may exist inherent limitations in a legal fraternity which is always seeking to implement reforms that reduce legal certainty, improve standing to sue, increase penalties and impose additional liability. Rather than suggesting that the CLERP reforms have gone too far, this article considers that the deregulatory momentum did not carry far enough.

While the economic profession has to shoulder some of the blame for not adequately addressing these concerns, the legal community should be capable of its own accord to engage in an all-encompassing regulatory reform debate that recognises these legitimate considerations in relation to regulatory costs.

[127] M Adams and M Freeman, "The Securities Market in Australia" in G Walker and B Fisse (eds), op cit n 13, p 135. Although, not all legal theorists are supportive of empirical research: "I have heard it said of empirical research on the legal system that there are just two types of empirical questions about law: questions not worth asking and questions impossible to answer" (R Posner, *The Problematics of Moral and Legal Theory* (1999) p 217)

[128] B Niskanen, "The Total Cost of Regulation" (1991) 14(3) *Regulation* 23; T Hopkins, "The Costs of Federal Regulation" (1992) 2 *Journal of Regulation and Social Costs* 5; S Goldsmith, "Regulation and the Urban Marketplace" (1994) 17(3) *Regulation* 76; E Hudgins, "State Regulatory Measures" (1996) 19(2) *Regulation* 25 at 27: "the annual federal regulatory burden is over $600 billion"; W Niskanen, "Clinton's Regulatory Record: Policies, Process and Outcomes" (1996) 19(3) *Regulation* 25; S Ellis, "Red Tape Costs $4,000 a year", *Australian Financial Review*, 11 October 1996, p 14; Anon, "The Hidden Cost of Red Tape", *The Economist*, 2 August 1996, p 11: "The cost of complying with America's federal regulations has risen to 47% of its federal budget, up from only 40% in 1988"; Anon, "Over-regulating America: Tomorrow's Economic Argument", *The Economist*, 2 August 1996, p 17; C Sunstein, op cit n 30; R Romano, op cit n 5 at 2375: "the termination of the SEC's mandatory periodic disclosure programs would reduce corporate disclosure costs by at least $213 million [US$ in 1975]".

[129] F Miley and A Read, "Cultural Differences in the Attitudes to Securities Market Regulation: The Case of the Barings Collapse" (1996) 7 *Australian Journal of Corporate Law* 105 at 106-107.

Some of the costs of Australia's securities regulations are well-documented.[130] There are several studies which have identified the excessive costs associated with securities transactions, particularly for smaller issuers.[131] Nevertheless, one area in which economists and lawyers can make a significant, positive contribution to the regulatory debate in Australia is in additional examination and research of the aggregate costs of securities regulation. Much work remains to be done.

On a related point, at the present time there is a distinct onus on the advocates of deregulatory reform to justify the use of cost-benefit assessments and to prove the inefficiency of securities regulations. It is submitted that the maturity of the regulatory reform debate will be measured in future by the extent to which that onus has shifted such that advocates of the current regulations, and proposed incremental regulations, need to establish the efficiency, cost-effectiveness and equity of those regulations.[132]

As demonstrated by the CLERP and Office of Regulation Review projects, there is a growing awareness of regulatory costs and it is to be hoped that this trend will result in more thoughtful, and appropriately founded, regulatory debate. However, it is still necessary, in this reviewer's opinion, to undertake a fundamental review of Australian securities regulation, guided by empirical analysis, where the assumptions which form the basis of the regulations are held up to serious scrutiny.[133] The need for such a review is premised on the benefits from lower regulatory costs and the increasingly apparent need to reduce regulatory burdens.

Conclusion

The debate over the appropriate level of securities market regulation has tended to proceed on the basis that more stringent regulations will, among other things, improve market confidence.[134] The theoretical foundation and empirical reality of such a contention is rarely challenged. Reliance on legislative solutions for economic problems may, with the benefit of hindsight, turn out to be flawed to the extent that they serve to both, firstly, increase compliance costs for the community and, secondly, reduce the competitiveness of Australian businesses. There are, however, some recent indications that academics, commentators, students and law reform bodies are showing an increasing awareness of regulatory cost issues. In particular, the Corporate Law Economic Reform Program is to be applauded for adopting and implementing an economic analysis when considering the assumptions

[130] CipaNet International, *A Study of the Cost of Small Entities Obtaining and Maintaining an Official Listing on the Australian Stock Exchange* (1996) p 7; Corporate Law Economic Reform Program, op cit n 1, pp 12-13; I Lee and S Lochhead, op cit n 37.

[131] E.g. Corporations Law Simplification Program, *Fundraising: Trade Practices Act, Section 52 and Securities Dealing* (1995); CLERP Fundraising, op cit n 1; Industry Commission, *Informal Equity Investment: Small Business Research Program* (1997); Small Business Research Program, *Investment Readiness Study* (1997).

[132] Of course, the costs of regulation may be fully justified on economic, equitable, moral or religious grounds. There will, inevitably, be some trade-offs in repealing pre-existing regulations and in not legislating for proposed regulations. However, the explicit recognition of those trade-offs will constitute a significant improvement over the complete omission of any regulatory cost considerations.

[133] Similar comments could be made in relation to the Eggleston Principles which form the basis of Chapter 6 takeover regulations in the Corporations Law. "One consequence of having mandatory takeover rules is that the cost of takeovers tends to be raised, thereby reducing the scope to improve the efficiency with which corporate assets are used through changes in corporate control.": OECD, op cit n 55, p 115.

[134] Some of the best examples of this implicit assumption can be found in the first edition of the text: G Walker and B Fisse (eds), op cit n 13.

underlying proposals for regulatory reform.[135] Nevertheless, within the legal academic discourse there is a pervading implicit presumption that the failure to regulate any aspect of our modern economy represents an 'anomaly' which should be rectified by more stringent regulations.[136] As a result, the debate over law reform in Australia requires the proponents of deregulation to stipulate the basis on which they would *not* regulate a particular element of our capitalist economy. This is in marked contrast to the general presumption in modern, mixed-economy capitalism where the onus of proving that market failure costs exceed regulatory failure costs usually falls on the proponents of additional regulatory burdens.[137]

Fortunately, the benefits derived from efficient securities regulation and, in particular the costs of regulating that sector of our economy, are slowing permeating the regulatory debate in Australia and, to a larger extent, overseas discourses.[138] These considerations are an integral part of evaluating the efficacy of securities regulations. Any academic discourse must be cognisant of these considerations if they are to faithfully reflect the parameters and constraints of our regulatory reform options.

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[135] Commonwealth of Australia Treasury, *Corporate Law Economic Reform Program - Policy Framework* (1997); see also Industry Commission, *Availability of Capital* (1991) Part 9.5; Wallis Inquiry, op cit n 115; ORR Review, op cit n 30.

[136] A good example of this attitude is the statement that "given the importance of dividends in finance and corporate law, it is an anomaly that they are only marginally regulated": J Farrar, "Australia's Dividend Laws: The Case for Mandatory Disclosure of the Dividend Decision" (1998) 20 *Sydney Law Review* 42 at 44 n 7 (this quote is made in reference to the article K Arjunan and C Low, "Dividends: A Comparative Analysis of the Provisions in Hong Kong and Australia" (1995) 5 *Australian Journal of Corporate Law* 455 at 457. It should be noted that Farrar's article does not start with this presumption and, in fact, represents a notable article in the Australian discourse for performing, as it does, a comprehensive cost-benefit analysis of regulatory reform).

[137] In corporate law, the suggestion has been made that any reform proposal should avoid focussing on the pathology of company law, and that reforms should resist the leap from the potential for abuse to the "need" for regulation: D Goddard, above n 54.

[138] E.g. K Lapidus, "Venture Capital and Rule 144: The Chilling Effect of Securities Regulations on Venture Capital Investing" (1998) 26 *Securities Regulation Law Journal* 75 at 75-77: "SEC Rule 144 adversely affects the liquidity and cost of raising venture capital… Ultimately, the cost of raising venture capital increases, which has a detrimental effect on the availability of funds in this critical area." See also F Easterbrook and D Fischel, op cit n 82, pp 296ff.

Appendix A

Explanatory Variables	Dependent Variables	
	NZSE(1)	**NZSE(2)**
CA 93	-0.219 (-1.843)	-0.013 (-0.061)
SAA88	-0.203 (-1.664)	-0.015 (-0.120)
%GDP(+1)	10.732 (8.762)**	--
%CPI(+1)	7.553 (6.770)**	--
Nt(+1)	0.084 (2.602)**	--
Intercept	-1.406 (-5.260)**	-0.041 (-0.380)
F-value	22.04	0.0079
Adjusted R^2	75.04%	-6.01%
Number of Periods	36	36

Note:

NZSE = New Zealand Stock Exchange movements as measured by the New Zealand Capital Index

CA93 = *Companies Act* 1993, equal to "1" for those time periods when the legislation was in existence, otherwise equal to "0"

SAA88 = *Securities Amendment Act* 1988, equal to "1" for those time periods when the legislation was in existence, otherwise equal to "0"

%GDP(+1) = New Zealand economic growth as measured by GDP brought forward one period

%CPI(+1) = New Zealand national inflation rate brought forward one period

Nt(+1) = New Zealand national unemployment rate brought forward one period

Intercept estimates the value of the dependent variables in those situations where all the explanatory variables are equal to zero

F-value and **Adjusted R^2** measure the overall statistical "goodness of fit"

** = statistically significant at the 10% level of significant

Source:

J Lawrence, "Market Confidence and Securities Regulation: Empirical Insights" (Working Paper, Centre for Corporate Law and Securities Regulation, The University of Melbourne, 1996)