Paul Latimer
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Promoting Information in the Marketplace for Financial Services

Financial Market Regulation and International Standards

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Preface

After every 'boom' and bust', legislators around the world pass new disclosure legislation, often in a heated environment fuelled by politics and the media with little regard for existing regulation or with no memory of the experience and outcomes of earlier regulation. This results in the enactment of continuing amounts of duplicating and overlapping disclosure laws in securities (financial services) regulation.

As authors from the new world and the old world, we have blended our financial markets research and scholarship with legal and regulatory perspectives in an attempt to present our findings in a business context, avoiding legalism.

We assess the effectiveness of the burgeoning numbers of disclosure laws, their administration and their enforcement because, as is often said, financial markets are markets for information. Because current disclosure laws are disparate and piece-meal with no common foundation, arguably they unfairly leave financial market stakeholders not fully informed. We examine reasons for the failures of financial services regulation to ensure and to promote the disclosure of information in the marketplace for financial services. We argue that the solution is a short easily understood, principles-based, plain English safety-net amendment to statute law like 'you must keep the financial market fully informed' to support effective mandatory continuous disclosure of information to financial markets.

In Chap. 1, we analyse the role of financial markets and explain the importance of promoting and ensuring information in the marketplace. We follow this in Chap. 2 by showing how the efficient operation of financial markets is dependent on disclosure, and that less disclosure results in less informed and therefore less efficient financial markets.

Chapter 3 presents the framework for the regulation of financial markets and examines the reasons why financial markets call for regulation. It concludes that the overlaps and inconsistencies in these different laws hamper the full disclosure goal of financial markets regulation. In Chap. 4, we examine the adequacy of the common law and the civil law on broker/client disclosure and the requirement of fair dealing by financial services intermediaries as a source of disclosure. We

conclude in Chap. 5 that although industry licensing in itself fails to keep the market informed, an occupational standard to require financial services licensees to provide financial services 'efficiently, honestly and fairly' could be promising.

Chapter 6 would like to say that securities commissions are able to achieve disclosure in financial markets, but we conclude that regulation of disclosure by commission alone is not as effective as the regulation of disclosure by a commission when balanced with coregulation by the stock exchange (financial market) building on its self-regulation. We support the role of stock exchanges in Chap. 7 as self-regulators to ensure disclosure to the marketplace but only when supported with coregulation with commissions holding the shotgun behind the door, in the words of a former SEC chairman.

We would like to thank the Department of Business Law and Taxation at Monash University in Melbourne, Australia and the TUM School of Management at the Technische Universität in München, Germany for their the support in the form of the facilities and infrastructure which have facilitated our financial markets research.

This book is current at April 2014.

We would appreciate feedback from readers.

Melbourne, Australia — Paul Latimer
Munich, Germany — Philipp Maume
1 May 2014

Dictionary

'Broker'. In this book, we use 'broker' in the everyday sense for a financial services intermediary (middleman, retailer, adviser) including a stock exchange participant. The correct technical description is financial services intermediary (which includes financial planners and investment consultants).
'Commission'. In this book we use 'commission' instead of securities commission or regulator to include the 123 ordinary members and most of the associate members of the International Organization of Securities Commissions (IOSCO), based in Madrid. If the discussion is specific to a specific commission such as the Australian Securities and Investments Commission (ASIC), the Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin, Germany), the Indonesian Capital Market Authority (BAPEPAM), the Securities and Exchange Organization (SEO, Iran), the Capital Markets Authority (CMA, Uganda), the Financial Conduct Authority (FCA, UK), or the Securities and Exchange Commission (SEC, USA), we use its name in full. Sometimes we use 'government' to include those few jurisdictions whose financial markets are regulated by government, not by a commission.
'Coregulation' occurs when regulation is a mix of self-regulation by the industry (the regulated) and regulation by the commission (independent of government control). The advantages, disadvantages and effectiveness of coregulation are an important part of Chap. 7. Coregulation is best summarized by the memorable words of former SEC Commissioner and later US Supreme Court Justice William O. Douglas that '(t)he exchanges take the leadership with the Government playing a residual role. Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used' (William O. Douglas, *Democracy and Finance* (Yale University Press, 1940) 82). The working relationship we have in mind for coregulation is self-regulation by the stock exchange including the principles-based requirement of disclosure we recommend in this book—based upon its experience of the market—under the watch of the commission.
'Financial market' is a market where financial products are traded, and is most commonly a stock exchange.

'Information'. Information is any communicating or imparting of knowledge, intelligence, and news. Information is to be distinguished from advice.
'Intermediary'. See broker.
'IOSCO', the International Organization of Securities Commissions. IOSCO, based in Madrid, Spain, is the international body that brings together the securities regulators of the world, including all the major emerging markets jurisdictions. IOSCO as the global standard setter for the securities sector develops, implements, and promotes adherence to internationally recognized standards for securities regulation. It works with the G20 and the Financial Stability Board (FSB) on the agenda of global regulatory reform. IOSCO's membership, which regulates more than 95 % of the world's securities markets, includes over 120 securities regulators and 80 other securities markets participants (stock exchanges; financial, regional and international organizations). See further www.iosco.org/about.
'Licensee'. See broker.
'Market integrity' refers to compliance with rules which deal with the activities or conduct of stock exchanges (licensed financial markets), the activities or conduct of persons with respect to stock exchanges and the activities of persons in relation to financial products traded on stock exchanges. These build on the Oxford English Dictionary (OED) explanation of integrity referring to a situation which is unimpaired and uncorrupted, and where there is truth and fair dealing.
'Marketplace'. The marketplace for financial services carries forward the original meaning of marketplace as a place where a market (trade) is held. The OED defines marketplace 'Any place or environment where ideas, etc., are sought or exchanged. Usually with distinguishing word designating the type of environment.'
'Regulation' is the control or influence of conduct or behaviour by rules or restrictions.
'Securities regulation'. We generally use 'financial services regulation' (English usage) instead of 'securities regulation' (North American usage). Their meaning is the same, and sometimes for the convenience of readers we use the two together.
'Self-regulation' means self-governance by a body such as a club formed by its participants as a 'self-regulatory organization' (SRO) or a 'self-governance organization'. The advantages, disadvantages and failure of self-regulation in financial markets are an important part of Chap. 7.
'Share'. International usage is to use the word 'security' for all investments on stock exchanges including shares.
'Stakeholders' for the disclosure of information in financial markets include persons having an interest such as investors, shareholders, creditors, and regulators and governments.
'Stock exchange'. In general discussion, we use 'stock exchange' rather than some local expressions such as Australia's 'licensed financial market' or Hong Kong's 'exchange company'. It has the same meaning as the term 'securities exchange' which emphasizes that various kinds of securities (stocks, bonds, derivatives) are traded on the exchange. In some contexts, we use 'stock exchange' in a wider sense to include any regulated or self-regulated financial market.

List of Abbreviations

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AASE	Association of Australian Stock Exchanges
ACL	Australian Consumer Law (Competition and Consumer Act 2010 (Cth) Schedule 2)
ASC	Australian Securities Commission (old name until 2001)
ASIC	Australian Securities and Investments Commission (from 2001)
ASX	Australian Securities Exchange
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Germany)
BAPEPAM	Indonesian Capital Market Authority
CEO	Chief Executive Officer
DFSA	Dubai Financial Services Authority (United Arab Emirates)
DPP	Director of Public Prosecutions
EBA	European Banking Authority
ECMH	Efficient Capital Markets Hypothesis
ED	Enhanced Disclosure
EIOPA	European Insurance and Occupational Pensions Authority (Germany)
ESFS	European System for Financial Supervision
ESMA	European Securities and Markets Authority
FATF	Financial Action Task Force
FCA	Financial Conduct Authority (United Kingdom)
FINRA	Financial Industry Regulatory Authority (United States)
FMA	Financial Markets Authority (New Zealand)
FSA	Financial Services Authority (United Kingdom)—disestablished 2013
FSB	Financial Stability Board
GFC	Global Financial Crisis 2007/2008

Gower Report	United Kingdom Government Report, Financial Services in the United Kingdom—A New Framework for Investor Protection (Cmnd 9432, London, 1985)
ICC	International Chamber of Commerce (France)
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IOSCO Methodology	International Organization of Securities Commissions, Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (September 2011)
IOSCO Principles	International Organization of Securities Commissions, Objectives and Principles of Securities Regulation (last revised 2010)
IPO	Initial Public Offering
ISA	Israel Securities Authority
LIBOR	London Interbank Offer Rate
LSE	London Stock Exchange
MiFID	Directive 2004/39/EC of the European Parliament and of the Council on Markets in Financial Instruments (21 April 2004) [2004] OJ L-145 1
MOU	Memorandum of Understanding
NASDAQ	National Association of Securities Dealers Automated Quotations (United States)
NYSE	New York Stock Exchange
NZX	New Zealand Exchange
OED	Oxford English Dictionary
OPEC	Organization of Petrol Exporting Countries
OTC	Over-the-Counter
PM	Prime Minister
Reg FD	Securities and Exchange Commission (United States), Regulation Fair Disclosure, 17 CFR 243.100-243.103
s	A section in a statute, like s 18
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission (United States)
SEO	Securities and Exchange Organization (Iran)
SRO	Self-Regulatory Organization
SSB	Shari'a Supervisory Board
SSO	Standard-Setting Organization
WFE	World Federation of Exchanges

Contents

Chapter 1
Introduction: Promoting Information

Abstract After every 'boom' and 'bust', legislators around the world pass new disclosure legislation, often in a heated environment fuelled by politics and the media with little regard for existing regulation or for prior experience. This results in continuing amounts of duplicating and overlapping disclosure laws in securities (financial services) regulation. This book calls for assessment of disclosure laws, their administration and their enforcement. To earn investor confidence, financial markets depend on cultures of disclosure and compliance with the law. Disclosure is important because, as is often said, financial markets are markets for information. There are issues with disclosure, including the problems of cost of disclosure, conflicts of interest between the different needs of management and users in what to disclose and how to disclose it. The result is disparate and piecemeal disclosure laws with no common foundation, unfairly leaving stakeholders not fully informed. We argue that the solution is a short principles-based plain-English safety-net amendment to statutory laws like 'you must keep the financial market fully informed' to support effective mandatory continuous disclosure of information to financial markets, under the effective cooperation coregulation of both commission and by stock exchange.

> The value of a well-informed securities market is almost universally acknowledged. But that today's securities markets are well informed is a myth. Uneasiness about the present state of practice is widespread. But the will to reform it is weak and fugitive. Old habits die hard, especially when they serve specific parties at concealed costs to others. (Ray Chambers[1])

1.1 Background and Motivation

Legislators around the world continue to pass new disclosure legislation, often in a heated environment fuelled by politics and the media, with little regard for what is already in place or for what has gone before. Our book argues that there are now too many duplicating and overlapping disclosure laws in financial services regulation

[1] Chambers (1973), pp. ix and x.

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and that the time has arrived for reassessment and improvement. The result is disparate and piecemeal disclosure laws with no common foundation.

The question we are going to answer in this book is whether disclosure laws in financial services contained in legislation, at common law and in equity result in the financial market being more informed or less informed. What is best for stakeholders? For market integrity? Our book analyses the paradox that more legislation results in the markets becoming less informed. This was adverted to in what Beaver calls the 'myth of information needs'—the paradox that rules on disclosure will inflict more damage on investors, the intended beneficiaries of the Securities and Exchange legislation in the US than if there were no regulation at all.[2] This was also noted by a review panel when it stated correctly that 'excessive or complex information can be counterproductive as it may confuse consumers and discourage them from using disclosure documents'.[3] Human channel capacity is limited and can be overwhelmed by information overload.[4]

Every time there is a new crisis in the economy, there is an investigation, and another new disclosure law is usually passed. For example, the report which followed the South Sea crash in 1720 described the Bubble Act as 'like all laws passed upon the exigency of an occasion, (with] . . . more of temporary malice and revenge than of permanent wisdom or policy'.[5] The current regulation of disclosure has evolved—and continues to evolve—piecemeal over many years, generally after a crisis, such that disclosure law is now unsettled, inconsistent and lacks any conceptual basis. Investors with imperfect information still lose money after investments in failed companies. Can effective financial regulation stop this?

Evidence of lack of information in the marketplace and uninformed investment decisions in household names re-emerges as an issue after each market crash such as Tulip mania (1637), the South Sea Bubble (1720), the Great Depression (1929–1932), the 'Poseidon Boom' (Australia, 1970s), the Black Monday stock market crash (October 1987), the Asian Financial Crisis (July 1997), the burst of the Dot-Com Bubble (2000) and the passing of the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US in 2010 after the Global Financial Crisis (2007/2008). Some of these are discussed below in Chaps. 2 and 3.

The correct information and the full disclosure that investors needed at the time will slowly emerge—after the failures and after investments were lost. The unsettled nature of the law has generated, and will continue to generate, costly and possibly fruitless litigation for regulators as they seek to enforce the law. It will generate equally useless litigation as stakeholders such as investors and shareholders seek to recover their losses. An uninformed market—a market without market integrity—can harbour corporate fraud such as insider trading.

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[2] Beaver (1978), pp. 44 and 52.

[3] Commonwealth of Australia (1997), p. 261.

[4] Paredes (2003), p. 417.

[5] Hunt (1936), p. 8.

For these reasons, our book argues that the current law contained in legislation—and at common law and in equity—does not meet the informational needs of stock exchange stakeholders such as commissions, creditors, governments, investors, regulators, shareholders and users. Each of the chapters demonstrates a different aspect of this non-disclosure to the market. The current law of disclosure is unfair and even detrimental to stakeholders, including governments and regulators, who rely on it unaware that it is incomplete. We use the word 'unfair' rather than 'not efficient' on purpose, because in their ignorance of what should have been disclosed, any of these stakeholders can, may and do make wrong decisions. These wrong decisions can, may and do impact on financial markets and the national economy. Informed investors who rely on their own research at their own cost may be able at cost to discover what could have been provided by companies at a fraction of the cost.

The evidence chapters of this book demonstrate the unjustifiable differences and inconsistencies in disclosure law which result from corporate legislation and at common law. For example, stakeholders cannot rely on the law of broker and client to lead to disclosure. It is not settled whether contract law imposes an implied term of good faith to require disclosure, or whether there is a stock exchange usage to require disclosure (as discussed in Chap. 4). The equitable obligation of a fiduciary to disclose conflict of interest is a good start, but equitable obligations can be exempted (as discussed in Chap. 4). Besides, civil law based jurisdictions put less emphasis on fiduciary duties (or do not know them at all). The licensing of those in the financial services industry has the potential to set high standards of conduct—including disclosure—from the license obligations of licensees to provide financial services efficiently, honestly and fairly (as discussed in Chap. 5). Whether securities commissions can regulate to ensure disclosure in the market is examined in Chap. 6. Self-regulation by stock exchanges could develop a rule for disclosure under stock exchange rules (Chap. 7). Examining the conceptual basis of the law shows that legislatures and courts alike do not have a settled theoretical framework on disclosure. This book also analyses the mixed enforcement of disclosure law—by commissions, by stock exchanges or by these together under coregulation and attempts to assess which option is more effective.

A separate and far more contentious matter is whether the substance of the law is fair to stock exchange stakeholders, including governments and commissions (regulators). Again, the examination of the different laws shows arguments both in favour of, as well as against, the existing disclosure laws. This book concludes that the existing disclosure laws would be clearer with one principles-based plain English safety-net statement with an ethical tone that '(y)ou must keep the financial market fully informed.' This would be a principles-based statement which would set out the basic duty owed to clients by those in the investment business. This is an aspirational principle which builds on current best practice. A major advantage of such a principles-based approach is that it makes national decisions more comparable than the heavily prescriptive laws which are introduced all around the world. Courts and regulators could draw on persuasive rulings from various countries, which would enable an internationally coherent application of disclosure

obligations. Our approach would be intended to be sufficiently general to readily apply to new situations arising in response to developments in the rapidly changing financial sector in different regional markets. It would provide a plain English standard of conduct with an ethical tone which would be confirmed through precedent and rules for the provision of financial services.

The authors do not presume to be able to determine the 'correct' way the law should proceed, given that numerous legislators, judges, commissions, academics and the like have attempted to promote disclosure and have provided different answers. Nonetheless we do make some recommendations at the conclusion of the book which will seek to balance the rights and obligations of the stakeholders in the light of the social, legal and economic factors regarding disclosure.

1.2 The Broad Issues of Disclosure

1.2.1 The Importance of Disclosure in Financial Markets

Financial products (which include securities) are different to goods. Financial products include a 'security'. Securities are different to goods.[6] They are not merchandise information which the buyer can examine, investigate or test, no matter how expert. Financial products give rise to unique regulatory issues as they have no value in themselves. Their value depends on the condition of the issuer/promisor and what others are prepared to pay for them. The value depends on the issuer's financial condition and its future earnings—information which the investor usually has no access to. It also depends on its products and markets, management and the competitive and regulatory business climate that the issuer operates in. Financial products are a claim to the future income of firms and, as such, they represent a right to something else.

Financial products can be created on the primary market to raise capital, inter alia, by the issue of shares to investors. They can be produced in virtually unlimited numbers in the primary market virtually without cost, as they are nothing in themselves. They represent an interest in something else. Financial services laws try to ensure that stakeholders—including investors—have an accurate idea of what that 'something else' is. There are good economic and other reasons to require a different regulatory approach to the rule of *caveat emptor* for securities. In contrast to many other commercial situations, financial services legislation aims to provide some protection and disclosure for the purchaser of securities.

Financial products are not used or consumed by purchasers. They become a kind of currency, traded on secondary markets—either stock exchanges or 'over-the-counter'[7] markets—and they trade at fluctuating market prices. The turnover

[6] See, e.g., Coffee et al. (2012), pp. 4 and 5; Ratner and Hazen (2002), pp. 1–3.

[7] See, e.g., Latimer (2009a), p. 9; Latimer (2009b), p. 55.

(volume of secondary trading) far outnumbers the number in the primary issue when they were floated. One of the purposes of the regulation of financial products is to ensure that there is a continuous flow of information about the issuer/corporation, with additional information/disclosure whenever investors are asked to vote and/or to make a decision. The failure of voluntary disclosure, and the reasons and policy options for mandatory disclosure and/or continuous disclosure, are set out in Chap. 2. The fact that financial products are different to goods underlies the importance of the market for information.

The marketplace for financial services is where trades take place and where market information is generated. To earn investor confidence, financial markets depend on cultures of disclosure and compliance with the law. Information must be publicly available to enable the decision making which underlies the efficient allocation of resources. The market must have information to be able to monitor performance.

The financial market is a market for information. The stock market is like a sponge when it absorbs and displays all information. The market reflects that information. When the economy is good, the stock market is good; when the economy is bad, this is reflected in the market.

Information is crucial for investors. All investors need information to make an informed decision, as shown by these quotations in chronological order:

> 'Publicity is all that is necessary. Show up the roguery and it is harmless'.[8]

> 'Men in high positions in corporations have often done in secret, in the way of chicanery what they would have been both ashamed and afraid to do openly'.[9]

> 'Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman ... That potent force (i.e. publicity) must, in the impending struggle, be utilised in many ways as a continuous remedial measure'.[10]

The need for informed markets relates to the efficiency of investment decisions and the overall market outcome. Information improves investment decisions, the monitoring by stakeholders and the accountability of management. This is one of the central aspects of the efficient market hypothesis which has heavily influenced the regulation of the financial markets since the 1970s. A well-informed market will provide a certain level of investor protection as the quality of an investment is reflected in its price, warning potential investors of low quality products.[11]

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[8] W.E. Gladstone, former British Prime Minister, 1844, when Secretary of Trade, in the House of Commons, quoted by Knauss (1964), pp. 607 and 611.

[9] Clewes, cited in his *Fifty Years in Wall Street* (1908), p. 1053, quoted by Seligman (1983), pp. 1 and 45.

[10] Brandeis (1914) Ch 5 (What publicity can do) 92; a title which to this day remains part of our national vocabulary. Brandeis was referring to the influence of the private investment banker such as the House of Morgan: Pecora (1939), p. 75.

[11] See discussion in Chap. 2.

It is important to actively promote information in the marketplace for financial services. Disclosure is for the investor and their financial services advisers who can assimilate the public information and whose judgment will be reflected in the market price.[12] An informed investor who makes errors will only have themself to blame and cannot turn to regulation to reverse a bad decision. The cost of errors of judgment will, quite correctly, ultimately be borne by those responsible. In our view there is no justification for regulating capital markets to protect investors, corporate or individual, from the effects of their own freely chosen investment decisions.[13]

It is not possible to let all investors, even sophisticated investors, look after themselves if they are acting on incomplete information. Failed or incomplete information disclosure results in bad investment decisions ('adverse selection'). Inefficient investment behaviour makes it less attractive for offerors of good products to remain in the market, impeding on the overall market result.[14] A second implication of the information asymmetry problem is that market participants with superior knowledge are tempted ('moral hazard') to use their information for insider trading or market manipulation.

Therefore one of the objectives of financial markets regulation is to ensure that all investors have equal opportunity to equal access to public information relevant to the market such as published accounting information.[15] If investors believe they do not have equal access to information which has resulted in inferior trading results in comparison to other investments, they may reduce their participation in the market. The latter will make 'unfair' profits from trading on superior information. Even rumours of unfair use of information might be detrimental to investor confidence and might make them leave the market.[16] Large numbers of traders withdrawing from a financial market result in a thinner and more volatile market. This means that for equity reasons (fairness to all market participants), there should be mandatory disclosure. This 'legal genealogy' of investor protection through information disclosure has been a cornerstone of securities regulation since the nineteenth century.[17] The negatives of investors 'voting with their feet' underlies the analysis of the policy options for mandatory disclosure as set out in Chap. 2 of this book.

[12] See, e.g., Douglas (1934), pp. 521, 523 and 524, quoted by Karmel (2005), pp. 79 and 83. Douglas was a member of and later chair of the SEC, 1936–1939.

[13] English (1988), p. 45.

[14] This is known as the 'lemons problem': see Akerlof (1970), p. 488; Black (2001), pp. 781 and 786.

[15] International Organization of Securities Commissions (2011), p. 11.

[16] Bhattacharya and Daouk (2002), pp. 75–77.

[17] See Walker (2006), p. 481.

1.2.2 The Regulation of Financial Markets

All markets have rules, whether self-designed (self-regulation) or imposed from the industry or by government. Even the black market is not unregulated ('free'). Black market agreements may not fulfil government safety and information standards, but they may be enforceable by extra-legal means like force.

Market (business) rules will be in the form of regulation—whether self-regulation, coregulation or government regulation. For example, the role of a securities commission is to maintain, facilitate and improve the performance of the financial system in the interests of commercial certainty, to reduce business costs, to promote the efficiency and development of the economy, and to promote the confident and informed participation of investors and consumers.[18] The information which investors need can only be sourced from the company in which they are investing. The typical investor/buyer cannot examine the company, so financial services regulation must ensure that all investors have confidence that they have equal access to company information.

The level of disclosure required by financial markets is more than the level of disclosure required by the law of contract or fraud. Earlier works of law of finance argued that the markets should better be left alone, and that the existing law of contracts and torts would be sufficient.[19] Nowadays it is widely undisputed that financial markets benefit from a state-imposed set of rules that takes into account the particularities of financial markets.

Many financial services laws are disclosure laws.[20] An issuer can go public on the primary market if it makes full disclosure in its prospectus. This is reflected in Principle No. 16 of the International Organization of Securities Commissions' Objectives and Principles of Securities Regulation (IOSCO Principles), an international best-practice for the regulation of the financial markets.[21] For example, the *Securities Act of 1933* (US) (the Truth in Securities Act) has been described as a 'rotten egg' statute because it is perfectly acceptable under the Act to sell rotten eggs to the public so long as the seller discloses that they are rotten.[22] The 1933 Act provides 'clear presentation of factors of significance',[23] and as pointed out by Milton Cohen[24]

> It is the fate of all information originally filed under either Act to become stale sooner or later, in greater or lesser degree . . .for purposes of the continuing trading markets, the value of the original disclosures under the 1934 Act will gradually diminish to the vanishing point unless stale information is constantly replaced by fresh. The process of replacing stale

[18] International Organization of Securities Commissions (2010), principles 1–8.

[19] So-called 'Null-Hypothesis', for a comprehensive overview see La Porta et al. (2006), p. 1.

[20] Financial services laws do not provide merit regulation.

[21] International Organization of Securities Commissions (2010).

[22] See, e.g., Panel Discussion (1973), p. 505, 505 per A.A. Somer Jr.

[23] MacChesney and O'Brien (1937), pp. 133 and 153.

[24] Cohen (1966), pp. 1340 and 1356.

> information with fresh, in a continuous reservoir, is accomplished through periodic and current reporting requirements.

Despite the 'exceptionally strong statement'[25] of full disclosure obligations, Chambers pointed out there is no definition of accounting concepts like 'true and fair', 'profits' and 'results and the original cost base for reporting the amounts of assets'.[26] Further, the result is that the 1933 Act makes 'public offerings . . . subject not only to extensive disclosure requirements, but also to a byzantine array of gun-jumping rules limiting voluntary disclosure intended to curb speculative frenzies for newly issued securities'.[27]

Financial services laws require specified information to go on the public record, but is this the right information, or does it provide much scope for non-disclosure by burying non-disclosure in over-disclosure? Do legislation and common law and equitable principles lead to meaningful disclosure?

This book will examine the evidence for these propositions on disclosure by analysing broker/client laws at common law and in equity (Chap. 4). It will examine the effectiveness of licensing in Chap. 5 and whether the obligations of a licensee (such as a broker) can be relied on to produce disclosure. Chapter 6 examines whether a commission alone can achieve disclosure in the market. Chapter 7 concludes that self-regulation by stock exchanges alone will not produce disclosure, and that self-regulation is only effective when it is includes coregulation by the commission with the force of law. This book reiterates the words of the late Professor Ray Chambers[28] that[29]

> the provisions on disclosure of financial information (are) one of the key elements of the companies legislation. Financial information is the link between the investments and operations under the control of directors and managers and the different rights and interests of shareholders and creditors. The quality of that information determines whether the securities market is a fair market or a casino with loaded dice. The 1963 Report of the Special Study of Securities Markets, sponsored by the US Securities and Exchange Commission, observed . . . "Disclosure is the cornerstone of Federal securities regulation. It is the *sine qua non* of investment analysis and decision. It is the great safeguard that governs the conduct of corporate management in many of their activities. It is the best bulwark against reckless corporate publicity and irresponsible recommendation and sale of securities" . . . Ideally, no double. But the "great safeguard" is not as safe as it seems.

The book includes analysis of whether disclosure laws such as the US *Securities Act of 1933* and equivalents fail to produce disclosure. There is the argument that mandatory disclosure is a failure because the assumption that publicity—in balance sheets and other data—is lost and fails in the hands of the average investor, who either cannot understand it or who is only focused on speculative and/or short-term

[25] Cohen (1966), p. 1353.

[26] Chambers (1973), p. 19.

[27] Pritchard (2013), pp. 999 and 1003.

[28] 1917–1999, Order of Australia; Australia's pioneering accounting professor; details at http://fbe.unimelb.edu.au/accounting/caip/aahof/ceremonies/ray_chambers. Accessed 10 June 2014.

[29] Chambers (1973), p. 7.

profits. An investor needs information which can inform a decision on when to buy and when to sell. Without information, an investor may fall into the cycle of greed-hope-fear (the small investor cycle).

As Kripke highlighted, the comprehensibility of disclosure is a major concern of disclosure regulation. 'Even a sophisticated person reading a lengthy prospectus and supplemental information on a given company will not have the answer to his basic question – whether the proposed security is a good buy... A security has no investment merit except by comparison with numerous other available opportunities for investment'.[30]

1.2.3 Why Is Failed Disclosure Unfair to Stakeholders, Investors, Shareholders, Governments, Regulators?

Financial markets tend to produce inadequate information, and that they do not fully achieve their licence obligation of operating a financial market in a manner which is fair, orderly and transparent. The failure of accountability and transparency is unfair to stakeholders including investors and shareholders who are unable to make informed investment decisions, analyse and research data in the absence and ignorance of the correct information. They will not know when to buy and sell, and they will be at a disadvantage compared to insiders.

However, some stakeholders will have information. Inadequate disclosure will therefore facilitate market manipulation, and may motivate insider trading. It will facilitate such matters as conflict of interest and breach of fiduciary duties.

The failure of disclosure is unfair to commissions. Commissions aim to maintain, facilitate and improve the performance of the financial system and the entities in it, and to promote investor confidence. Inadequate information will motivate commissions to fulfil their brief by chasing shadows. Regulation will fail, resources will go to the wrong areas and there will be market failure.

The absence of the correct information in the marketplace for financial services is unfair to governments. Governments must respond to crises, and government may be galvanized into action in the public interest on the basis of wrong or incomplete information. For example, government and commission responses to the global financial crisis (GFC) have been made very publicly at short notice and they will lead to new legislation for the financial services industry. There is the possibility of a new transnational regulatory system. This is in line with political philosopher Machiavelli's comment in the sixteenth century,[31] that governments should never waste the opportunities provided by a crisis. It may transpire that the information on the GFC and its causes available to governments and commissions was inadequate and incomplete, yet new legislation to restructure the financial

[30] Kripke (1970), pp. 1151, 1169 and 1170.

[31] This is discussed in Chap. 3.

services industry will have been made. The new legislation may not be appropriate post-GFC, but it will remain in force until there are calls for repeal.

1.2.4 Three Problems of Information Disclosure

Disclosure is the key to the regulation of this particular market, and failed disclosure leads to unfair and inefficient market results. Regulation of the financial markets needs to facilitate the promotion of information via disclosure. However, regulation via disclosure comes with three major problems—its costs, inherent conflicts of interest and how to promote the information.

1.2.4.1 Cost of Disclosure

Information is a private good, not a public good, and it is produced at a cost.[32] Private goods have price excludability—once you pay the price, the good is yours. Private costs involved in disclosure may exceed its social benefit, which will reduce disclosure. The market produces the amount of information (the outcome) that maximizes social welfare. The market supplies information at a point where its marginal cost of producing the information equals the stakeholder's marginal benefit.

A competitive private market will not produce the optimal amount of the good, and will tend to underproduce information.[33] There will be market failure in the public dimensions which may lead to calls for a regulatory response to mandate disclosure of information to the market.

1.2.4.2 Conflict of Interest

The decision to disclose information in response to legislation or stock exchange rules will raise conflicts of interest between the self-interest of management and the demands of stakeholders. There is a natural self-interest not to provide negative information regarding one's competence and performance on grounds including maintenance of confidentiality and not giving away a competitive advantage. Management will act in self-interest (for self-protection, and not to lose their jobs, bonuses and other benefits). Agency theory demonstrates that managers will

[32] Public goods include public facilities like public parks, public places and public payphone boxes. Because these public goods cannot exclude users, they attract freeloaders who use or consume them without paying. Therefore public goods tend to be underprovided.

[33] Where there is perfect competition, a firm providing misleading or fraudulent information would ultimately be discovered by the market and may not survive.