**NEW ZEALAND BUSINESS ROUNDTABLE**

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# COMMENT ON LABOUR'S DISCUSSION PAPER

## *IMPROVING CONFIDENCE IN THE SHAREMARKET:*

## *TOWARDS A BETTER COMPLIANCE REGIME*

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**JULY 1999**

## 1.0 Introduction

1.1 This comment on the Labour Party's discussion paper (the Paper), *Improving Confidence in the Sharemarket: Towards a Better Compliance Regime* is made by the New Zealand Business Roundtable (NZBR), an organisation of chief executives of major New Zealand business firms. The purpose of the NZBR is to contribute to the development of sound public policies that reflect overall national interests.

1.2 The Paper favours greater regulation of takeovers and insider trading and greater coordination, if not amalgamations, of regulatory institutions and regimes. It asks for comments on these proposals and provides 11 specific questions to guide respondents.

1.3 The NZBR agrees with the Paper about the importance of investor confidence in the integrity of New Zealand's markets. It is critical for national prosperity, let alone the efficiency of markets, that laws against fraud and coercion are enforced, property rights and the sanctity of contract are protected, and the rule of law prevails.

1.4 We agree with the Paper that any issue of gaps in the law that might permit fraud, theft or coercion to flourish deserves serious consideration. Securities market regulation is a widespread phenomenon, although the details differ widely across countries. We should all keep an open mind about what New Zealand can learn from the experience of others. There is an extensive academic literature that offers theoretical and empirical guidance on sound policies.

1.5 We are encouraged that Labour has been prepared to disclose its thinking on such important policy issues in this way and to invite informed public comment and debate. We are pleased to participate in the same spirit and hope that Labour will take the same approach in relation to other major policy issues.

1.6 Section 2 sets out our framework for addressing the issues raised in the Paper. Section 3 applies this framework to the overall problems identified in

the Paper and the objectives it sets for public policy. Sections 4 and 5 apply it to issues that are specific to takeovers and insider trading respectively. Section 6 comments briefly on the structure for regulatory agencies. Section 7 presents some concluding observations.

## 2.0 Questions to consider in assessing regulatory proposals

2.1 In recent years, many countries have given serious consideration to the problem of how to improve the quality of their regulations. New Zealand shares in the common problem of too much regulation of dubious quality. The New Zealand Statute Book is reported to have comprised more than 60 volumes at an average of 800 pages in each volume back in 1978. On one estimate, 1,600 new pieces of legislation and 3,600 new regulations have been added in the last decade. In 1990 the Law Commission estimated that around 4,000 new pages are added to the volumes of legislation each year. In stark contrast, Hong Kong is reported to have fewer than 1,000 regulations in total affecting business.

2.2 Parliament's ability to make law far outstrips the ability of individuals to absorb its implications. An employment relations consultant has listed 10 Acts that have significant implications for employers and another 12 that are relevant. No small employer could hope to make time to understand all the ramifications. Few could afford much expert help. But this burden is surely minuscule when compared with the tax laws and intrusive and burgeoning safety and environmental regulation. Flying blind must be the order of the day for many New Zealand businesses. The largest spend millions of dollars a year, simply to minimise the risk of inadvertent breaches.

2.3 The general public must also, of necessity, be deeply ignorant of the implications of much of this legislation if rigorously enforced. Nor can there be much doubt that were it to be rigorously enforced, glaring inconsistencies, absurdities and inequities would result. No systematic process exists for weeding out outmoded, irrelevant or ineffectual regulations.

2.4 Inadequate laws, uncertainty about their application, corrupt or ineffectual enforcement, excessive delays and costs in obtaining legal remedies and unpredictable law making, either by parliament or the judiciary, all make a country less prosperous. It is highly desirable for commerce that law-abiding people know, at low cost, the difference between legal and illegal actions. Otherwise, reputable businesses will be deterred from participating in markets. 'Safe harbours' are highly desirable for this reason. Laws of uncertain application frustrate all affected parties, raise costs and reduce activity.

2.5 The OECD has produced many reports on the problem of improving the quality of regulation and the experiences of countries that have systematically attempted to ensure that regulations are more soundly based. As a result, it has proposed the following ten questions for evaluating regulatory proposals:[1]

(i) is the problem properly defined;

(ii) is government action justified;

(iii) is regulation the best form of government action;

(iv) is there a legal basis for regulation;

(v) what is the appropriate level of government for this action;

(vi) do the benefits justify the costs;

(vii) is the distribution of effects across society transparent;

(viii) is the regulation clear, consistent, comprehensible, and accessible to users;

(ix) have all interested parties had the opportunity to present their views; and

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1 See p 208 in *Report on Regulatory Reform: Volume II: Thematic Studies*, Organisation of Economic Cooperation and Development, 1997.

(x) how will compliance be achieved?

2.6 In New Zealand, Cabinet Office Circular CO (98) 5 requires Regulatory Impact Statements to accompany regulatory proposals taken to cabinet.[2] These statements require, *inter alia*:

- the problem to be clearly identified, taking care to focus on root causes rather than symptoms;
- the public policy objective to be specified, but not so as to align with (and thereby pre-justify) the particular effects of the proposed regulation. Rather it should be specified in relation to the underlying problem;
- feasible regulatory and non-regulatory options must be identified that could wholly or partly achieve the specified objectives; and
- all regulatory costs must be identified and the excess of benefits over costs demonstrated – as distinct from asserted – against all feasible alternatives.

2.7 We use the framework provided by CO (98) 5 to discuss the Paper's proposals in relation to takeovers and insider trading.

## 3.0 Application to the Paper's overall perspective

### Problem definition

3.1 The Paper motivates its proposals by expressing concern about:

- the low numbers of private investors in New Zealand relative to Australia;
- a poor sharemarket performance compared to Australia and some other countries since the 1987 sharemarket crash; and
- a relatively low number of registered companies listed on the New Zealand Stock Exchange compared with the pre-October 1987 situation.

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[2] Cabinet Office Circular CO (98) 5.

3.2 None of these concerns raises any issues specific to takeover or insider trading situations. The Paper simply presumes, first, that more regulation of takeovers and insider trading would materially raise the proportion of shares held directly by private investors, improve our relative sharemarket performance and increase the number of companies listed on our market; and, second, that all of this would be a good thing. The following subsections explore these twin presumptions.

***Low numbers of small shareholders relative to Australia***

3.3 The Paper gives no data establishing that such a gap exists. Nor does it identify how large is the alleged gap or whether it has changed. Even if a gap did exist, which is by no means established, it is not clear why a lower number of small shareholders than in Australia should be regarded with concern.

3.4 The suggestion by those promoting more regulation that low shareholdings by one group of investors (small shareholders) are a sign of too low a level of confidence implies, by the same logic, that the inevitably high share of at least one other group is a sign of too high a level of confidence. It is impossible for every group to have a high share. It is hard to make sense of such a self-contradictory proposition.

3.5 Another puzzle arises from the comparison with Australia. Why would we expect the proportions to be the same between the two countries? Have they ever been the same? Small shareholders can get their sharemarket exposures directly or indirectly through superannuation funds, listed or unlisted unit trusts and mutual funds, life insurance products and investment companies. Since diversification is sensible, it is sensible for many to avoid direct investment.

3.6 The same principle makes it rational for New Zealanders to own a smaller proportion of the New Zealand market that it would be for Australians to own of the Australian market. New Zealand's sharemarket is only 0.1-0.2 percent of the world market. Foreign exchange controls stopped New Zealanders from diversifying optimally until 1985. Nor were global investment vehicles as readily available then as they are today and will be tomorrow. New Zealanders are becoming more global in their investing and

they are making greater use of pooled investment vehicles such as unit trusts. Only those who fail to understand the benefits of diversification could find this disturbing. We should not be surprised to see, in due course, many New Zealanders having more than 90 percent of their sharemarket investments offshore.

3.7 Another feature of the New Zealand market that may be associated with size is the much greater significance of block shareholdings in this country. Often they take the form of a major overseas shareholder. Major shareholders can provide access to markets, finance, know-how, technology and employment opportunities that New Zealand companies often could not provide as well if at all. The implication is that fewer shares are available for local investors. But as just noted, they could be happy to diversify globally.

3.8 One possible answer to the puzzle of using Australia as the point of comparison is that those proposing greater regulation of the New Zealand market could want us to assume that Australia's sharemarket is more attractive to small shareholders because of Australia's takeover code. Indeed, that code does have a mandatory bid and equal price rule that the advocates of regulation defend on the grounds that such a rule 'protects' smaller shareholders. But good intentions do not necessarily lead to good regulations. Small shareholders do not benefit if a takeover code deters bids and thereby prolongs the existence of under-performing boards and management teams. Regulations have a cost. Small shareholders have a sharper incentive to worry about these costs than do those proposing more regulation.

3.9 What do we know about small shareholder preferences on this point? The first point is that if legislatures do not deprive small shareholders of the ability to choose, they overwhelmingly fail to demonstrate that they see an equal price rule as being in their interests. A century of revealed preferences demonstrates this in a passive way in New Zealand. When companies list on the sharemarket for the first time their pre-existing owners have to decide what rules in their articles of association will maximise the sum of the value of their ongoing shares in the company and the amount they will receive by selling shares to new investors as part of the listing process. Rules that disadvantage the new retail investors will depress the price at which these

investors subscribe. The lower price compensates those who invest for those rules. It also means that the pre-existing owners cannot themselves benefit from rules that impose costs on small shareholders. There is no free lunch for anybody. Nor is anyone compelled to buy shares or accept arrangements at other than a satisfactory price.

3.10 New Zealand's experience in the past one hundred years is no different from that of other countries in this respect. Small shareholders faced with choice have not generally preferred equal price rules. New Zealand recently tested this proposition explicitly when the New Zealand Stock Exchange obliged shareholders in each company to choose between three takeover rules. This process demonstrated beyond any doubt that small shareholders overwhelmingly do not feel strongly about the matter, *even after the company has listed.*[3] In company after company they voted to support the option their boards put in front of them. The few exceptions only served to prove the rule. In some of these exceptions the vocal shareholders were those most in favour of regulations that would deprive small shareholders of the ability to choose for themselves. The claim in the paper that "the reality is that very few companies have opted for this due to voting procedures" is simply wrong. Shareholder meeting after meeting saw the small shareholder category voting the same way as the large shareholder category. Again any exceptions were exactly that.

3.11 Putting the issue of shareholder preferences as revealed by history and voting to one side, data on small shareholdings could be examined to test the Paper's proposition that differences in the proportions of a sharemarket owned by small shareholders could be explained by differences in takeover codes. Were small shareholdings lower or higher before Australia adopted its code? How does Australia's proportion compare with those in other countries that do not have an equal price rule? The United States, for

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3 This is the more remarkable in that once shares have been bought at a price that would compensate small shareholders for the absence of an equal price 'protection', the imposition of a mandatory equal price rule should give small shareholders a free lunch. The passivity of the vast majority of small shareholders, even in the face of the emotion whipped up by the media, regulators and a handful of vocal, high profile, media friendly 'shareholder activists', is entirely consistent with the view that they see no net benefits in such a rule even if they have to pay nothing for it.

example, has no such rule at the federal level. Why not bring Asian and other countries into the comparison too? Have New Zealanders tended to invest more heavily in Australia than in the United States since Australia adopted its equal price rule? The proponents of an equal price rule have failed to consider any explanations for what they observe, other than the one that suits them.

***Poor sharemarket performance***

3.12 The implicit notion here is that poor quality regulations will produce a poor sharemarket performance. Those advocating greater regulation provide no rationale for such a relationship. This is a problem because standard finance theory would, if anything, postulate the opposite relationship. One of the most fundamental propositions in finance is that investors require a higher return where the risk is greater. Therefore, if a poorly regulated market is a source of risk for investors, poorly regulated sharemarkets should produce the highest returns, on average, other things being equal.[4] Those who favour regulation and attribute relative sharemarket movements to differences in regulations, ignoring all other factors, should conclude, if they understood basic finance, that New Zealand has the best arrangements. Of course their revised conclusion would be wrong because the influence of other factors cannot be ignored. Since those proposing greater regulation are happy to ignore the role of other factors when it suits them to do so, they would have to reject the revised conclusion on more expedient grounds.

3.13 No serious analysis could ignore the role of other factors. The pro-regulatory argument ignores entirely the fact that surprises are crucial to understanding observed returns. Again, it is scarcely believable that anyone with a sound grounding in efficient market theory and the propositions about the random nature of share price movements could overlook the possibility that disappointing movements in share prices are due to adverse news about

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4 Investors who are concerned about risk and return will invest in a poorly regulated market when prices are low enough and future dividends look promising enough to satisfy their requirements for expected return in relation to risk. Obviously they will only invest in a well-regulated market on the same basis. If a less well-regulated market is more risky, they will only buy into it if the expected return is higher than in a well-regulated market.

likely future earnings. Investors buy shares in the expectation of satisfactory future earnings growth in relation to the price paid. Bad news about the prospects for future earnings growth will cause share prices to fall. When the fall in earnings is economy-wide, most share prices will fall, perhaps markedly. Typically, therefore, a market as a whole will fall because there is economy-wide disappointing news.

3.14 The proponents of regulation after the 1987 sharemarket crash failed to consider the possibility that company earnings had fallen dramatically and that a large number of companies were insolvent for this reason. To the contrary, the Russell Committee famously declared that it was essential to implement its regulatory proposals in order to restore confidence in the sharemarket. It provided no evidence at the time that share prices were unduly low in relation to earnings. Certainly they were not too low with the benefit of hindsight. How regulations could restore property prices and economic growth was left to the imagination. In time, the Committee's prediction was falsified by the subsequent economic and market upturn – without the benefit of its proposed regulations. The British scheme of regulation which the Committee proposed has subsequently been abandoned in Britain, suggesting New Zealand was wise to reject it. Regrettably, history reveals a tendency for regulation to follow from major sharemarket crashes.[5] The opportunism of those making such self-justifying claims for their regulatory proposals is rational.

3.15 The powerful relationship between national economic performance and exceptional sharemarket performance is a matter of everyday observation. In the 1990s the United States economy has been extraordinarily strong, along with its sharemarket. Japan just as dramatically demonstrates the opposite combination. The recent Asian crisis saw Asian sharemarkets and economic growth turn down. Since the mid-1990s Australia has been outperforming New Zealand in terms of economic growth and sharemarket

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5 It is human nature to succumb to greed during booms and to seek to blame others for losses when the crash occurs. Accusations of foul play strike a responsive chord at such times.

performance. In turn New Zealand has been outperforming the worst-performing Asian countries on both counts.

3.16 Turning to hard data, Chart 1 in the Appendix shows the close relationship between New Zealand's relative sharemarket performance and its relative economic growth. The relationship between shocks to economy-wide performance and shocks to sharemarkets is so obvious that it is almost impossible to conceive of any respectable reason why the proponents of securities regulation would overlook it.

3.17 Chart 2 in the Appendix demonstrates another obvious and related point, namely that New Zealand's market has both outperformed and underperformed world markets since the 1987 crash. This is what efficient market theory would lead all who have studied it to expect. The regulators assume that poorly regulated markets will underperform consistently until better regulations are imposed. This amounts to saying that investors are stupid – they are happy to stay in the market at prices at which they repeatedly lose money. In fact numerous academic research articles support the now-uncontroversial proposition that movements in share prices are highly random. Persistently negative returns would be highly non-random.

3.18 Of course, in any period any given sharemarket may have under-performed or outperformed the world, or at least a few markets. Those favouring regulations may pick a historically high market peak to start the period and a low point to end it. This argument of convenience works best when the low point is the current period. In this case, the pro-regulation argument is that whatever upturns occurred in between these two points were more than offset by the falls in other sub-periods. "Of course, we know that markets are volatile", they might say, "but the overall negative return is what counts, and it cannot be denied". What this argument attempts to avoid is the dual response that (1) if the overall return is what counts, the regulators' own logic requires them to extend the start period back to the beginning of the market and (2) market swings can only be explained by surprises. Only a surprise change in regulation might be able to explain an observed change in share prices. There has been no surprise movement to less securities market regulation in New Zealand that could explain New Zealand's sharemarket performance since the October 1987 sharemarket crash. To the contrary there

has been increasing regulation of surveillance, disclosure, and liability through changes to the Companies Act, the Stock Exchange's listing requirements and new legislation. If disappointing sharemarket returns are due to bad regulations, as those promoting regulations would have us believe, the advocates of further regulation have to put their telescopes to their blind eye in order to draw their preferred conclusion.

***The drop in company registrations***

3.19 New Zealand experienced a major sharemarket boom prior to the October 1987 sharemarket crash. Investor confidence was extraordinarily high – in the absence of the regulation desired by the Securities Commission and in the presence of the Labour government's moves to free up the economy and rein in inflation and fiscal deficits. A large number of property and investment companies were floated during the boom. Most were too highly geared to survive the crash. The argument that New Zealand needs further regulation because our market is still no longer as swollen by property and investment companies as it was in 1987 can only prompt the question as to why the pre-crash situation should be regarded as the norm. Again it is hard to conclude that the choice of the period of comparison is other than self-serving.

3.20 To conclude, the requirement in CO (98) 5 that the case for regulation be based on root causes rather than symptoms is surely unexceptional. The regulators' arguments discussed above fail totally in this respect. Indeed, it is hard to even make a case that the first and last are symptoms of a problem.

3.21 The rationale for focusing on Australia when assessing regulations is truly puzzling. Why would New Zealand only compare itself with Australia? Australia's economic performance, while better than New Zealand's, is clearly mediocre. Only a defeatist about New Zealand's future would settle for the proposition that what Australia does provides the right model for New Zealand.

3.22 The inescapable conclusion is that the proponents of further takeover and insider trading regulation have given up on the task of putting forward any analytical case for the measures they propose. Instead they rely on *ad hoc* arguments based on implicit propositions that are contradicted by basic

finance theories, and on a casual empiricism that ignores all relevant factors except the most convenient one for their case. The phenomena just discussed are easily explicable by far more powerful, and unrelated, factors.

3.23 The dog that did not bark, by its silence, provided Sherlock Holmes with crucial information in one of Arthur Conan Doyle's novels. In the Paper, the telling clue is the absence of any reference to this point to any problems that specifically relate to insider trading or to takeovers.

***The public policy objective***

3.24 The Paper appears to have two distinct public policy objectives. Its title and much of its discussion suggests that a key concern is that New Zealand's "extremely light-handed" regulation may hinder our sharemarket performance. However, it also states on page 3 that Labour's "fundamental concern is the need to promote confidence in the [share]market". This is not the same as improving sharemarket performance.

3.25 A move to better or lower quality regulation of the sharemarket could surely raise or lower market prices as a one-off effect. This effect is worth having. That is why good rather than bad regulations are desirable, even if companies are unlisted and we cannot observe the effect. The objective of improving confidence is consistent with a desire to achieve a one-off effect on share prices.

3.26 However, only changes that have an enduring effect on the *growth* of company earnings per share can be expected to have an enduring effect on sharemarket performance. The Paper offers no mechanism by which a change in takeover or insider trading laws could be expected to change the *growth* in company earnings. Conceivably some relationship could be postulated, however tenuous and hypothetical, although it is not obvious what form it would take. Most obviously, it would work in the opposite direction since laws making takeovers more costly shelter boards of directors and managements that are failing to perform. However, even this proposition is tenous, for the reasons discussed earlier.

3.27 The fundamental factor driving sharemarket performance must be expectations about future company earnings. This is what rational investors attempt to price. Fundamental determinants of future company earnings

include the economy-wide rate of economic growth and the rate of growth in business productivity. They do not include securities regulation.

3.28 For these reasons, we focus in the remainder of this comment on the alternative objective of finding regulations that promise to give a one-off benefit to share prices in the form of a one-off but sustained lift in investor confidence.

3.29 The objective of lifting investor confidence is a strange one to use to drive discussions about securities regulation. Other factors may have a much greater bearing on investor confidence. For example, investor confidence can be expected to be affected by:

- worries about New Zealand's future growth prospects and policy drift;
- fears of a downgrade in New Zealand's credit rating;
- concerns about political stability in an MMP environment;
- uncertainty about future taxes affecting capital gains and high income earners;
- concerns about draconian penalties (eg earnings-related penalties) in proposed amendments to the Commerce Act when it is unclear what behaviour does or does not constitute a violation of that Act;
- concerns about the willingness of governments to expropriate shareholder wealth (through regulatory takings), as in the case of the forced separation of line and energy companies with no proof of wrong-doing;
- concerns about government regulations, such as environmental, health, safety and competition regulations, that undermine certainty about property rights and impose costs, yet have not been justified by any respectable cost-benefit test;
- a local environment that is sometimes seen to be anti-Asian, anti-immigration and anti-wealth; and
- central and local government opportunism at the expense of businesses, as is evidenced by the drive to recover from businesses

the costs of supplying public goods, and the unconscionable allocation of rating burdens on businesses based on spurious arguments about the concessional treatment of businesses for the purposes of income tax and GST.

3.30 A much more conventional statement of the objective of securities regulation would be to promote economic efficiency. Setting this as the objective for the proposed measures should lead to a search for problems that are specific to the regulations under consideration.

***Identification of options***

3.31 The Paper fails to identify alternative courses of action that might affect sharemarket confidence. There is absolutely no reason to believe that the options it does consider are likely to have any material influence on confidence compared with other factors, such as those listed above.

3.32 The Paper's concerns about sharemarket performance should surely be addressed at the effect of policy on the level of earnings and economic growth rather than on sharemarket confidence.

***Net benefits***

3.33 Net benefits are derived from a comparison of alternative courses of action, not from a comparison between the status quo and the proposed course of action. Because the Paper fails to consider alternative ways of promoting confidence it cannot establish that there are any net benefits to what it proposes.

***Overall assessment***

3.34 The Paper fails to identify the root causes of any problems. The one clear problem that it does identify (poor relative sharemarket performance) has obvious potential causes that the Paper does not consider. The most obvious explanation for this problem is low earnings and low economic growth. We are at a loss to understand how regulators can think that securities regulation can make the sharemarket feel more confident about earnings that do not exist.

3.35 If Paper's objective is to increase investor confidence, it would be useful to motivate this objective by establishing that there is a confidence problem. It

does not do so. The most obvious indicator of confidence in the sharemarket – its price-earnings multiple – does not indicate any confidence problem from a historical perspective. Of course, if expected earnings growth were higher, multiples would be higher. Multiples are higher at present in some faster-growing economies. But securities regulation cannot make investors more confident about future company earnings. While governments can influence expectations about future economic growth and company earnings in many ways, the Paper ignores all the possibilities but regulation. It thereby fails to establish any net benefit for its proposals in terms of the given objective.

3.36 The bottom line is that the proposed securities regulations need to be evaluated purely on their merits in terms of what they are attempting to do (eg curb specific forms of wrong-doing). We assess the merits of a drug not on the basis of its contribution to our daily diet but on how well it treats specific ailments. We should evaluate securities regulation similarly.

## 4.0 Takeover regulation

4.1 Takeover regulation has been intensively debated in New Zealand since the Securities Commission initially proposed the regulation of takeovers in the early 1980s. New Zealand and overseas academics have made notable contributions to the debate from the perspectives of law, economics and finance.

4.2 The debate appears to have reduced to two issues:

- the proposition that a more intrusive code is necessary to control wrong-doing (so-called 'looting') of companies; and
- the argument that a mandatory bid and equal price rule is desirable to protect small shareholders.

4.3 Major changes to the Companies Act and the Stock Exchange's listing rules and the advent of the Stock Exchange's Market Surveillance Panel have yet to be shown to be so deficient in relation to wrong-doing as to warrant the

addition of the proposed code. The Paper does not even mention this issue, so we say no more about it in this submission.

4.4 The Paper relies solely on the second argument. We have already commented on this argument in section 3. The argument is wrong about the reasons for shareholder choices. It is also totally dismissive of shareholder choice and shareholder democracy.

4.5 Professor John Pound of the Kennedy School of Government, Harvard University analysed this issue extensively for New Zealanders a decade ago. To the best of our knowledge, the proponents of such regulation in New Zealand have never provided rebuttals of his arguments in a form that could subject them to academic scrutiny in the conventional manner. A copy of his monograph accompanies this submission. A copy of the submission made by the NZBR on the proposed 1983 Takeovers Code is also included.

## 5.0 Insider trading legislation

5.1 New Zealand's insider trading laws are the result of shoddy, do-it-yourself economics and finance work by the Securities Commission that was rushed through parliament in the aftermath of the October 1987 sharemarket crash. The lead minister's rallying call was that it was necessary because the New Zealand sharemarket was the "last frontier of the Wild West". This was a totally inaccurate and irresponsible statement. That call and sympathetic post-crash public opinion sufficed to get the legislation past the objections of the more analytically minded.

5.2 The legislation failed to consider the problem as an issue of property rights in information. Typically, insider trading involves the wrongful use of company secrets. This is a matter between the owner of that information (typically the company) and the person who has abused the company's trust (typically an employee, manager, board member, senior shareholder or professional adviser). This issue might have been explored from the point of view of contract law and tort law. Issues of employment contracts, grounds for dismissal, recovery of losses from investments in information and reputation and the contractual relations between companies, advisers, boards

and shareholders arise. Other remedies for breaches of contract could have been explored.

5.3 Instead, New Zealand followed the route taken in some overseas jurisdictions of treating it as an issue between a buying shareholder and a selling shareholder. This legislation was known to have proven to be at best troublesome in these overseas jurisdictions. There was no reason to expect that New Zealand's experience would be any better. Today, it is difficult to think of anyone who supports the legislation as it stands. The flaws at the heart of the current approach include:

- the absence of an obvious victim – the shareholder unwittingly transacting with the insider is getting a better price at that moment than would have been available if the insider had stayed out of the market, thereby protecting the company's information;[6]
- its complete inability to penalise the insider who makes use of inside information by not transacting when he or she would otherwise have done so;[7]
- the uncertainty that is generated when legislators cannot define what is meant by such terms as "information given in confidence", "price sensitive", "likely to affect the market" and "tipping", and leave it to subsequent case law to define the boundary issues. Meanwhile, people who want to be law-abiding but who are dealing in financial markets do not know where they stand;
- its unavoidable insensitivity to the need for companies to use inside information with discretion. A rule forcing companies to publish to all or not tell (ie 'tip') at all denies companies an important property right in their own information;[8] and

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6 Insider trading is sometimes referred to as a 'victimless crime'.

7 This neatly illustrates the problem of focusing on transactions rather than on property rights information.

8 Normally, for example, companies would provide bankers, major shareholders and other important allies with sensitive facts in confidence that are important for monitoring and financial backing reasons but would be valuable to competitors.

- its intrusive effect on transactions that have been accepted for decades as acceptable business practice;[9]
- the adverse effect it has on certainty of contract because of the potential rewards if offers individuals to 'renege' on transactions and behave opportunistically;[10] and
- the opportunities it creates for competitors to use the regulations opportunistically for an anti-competitive purpose.[11]

5.4 New Zealand's legislation has clearly imposed significant costs on the community, particularly in respect of due diligence processes. It is hard to think of any clear benefit. Some might argue that the business community is much more aware now of the need to act with propriety. However, legislation may not change the climate of opinion about what is ethical behaviour. Instead, legislation that stands in the face of what is regarded as ethical behaviour (as in the due diligence case) could bring the law into disrepute.

5.5 When the legislation was introduced two scenarios were possible. One was that it would be ineffectual because it was too difficult to enforce. The other was that its effects would be draconian if it were vigorously exploited and enforced. There is evidence of both effects.

5.6 In this paragraph we summarise our analysis of the proposals in the Paper using the framework in section 2:

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How much they said would depend on the situation and the level of trust. Legislation that ties the hands of the person who is thereby 'tipped' interferes with the company's ability to communicate.

9 The due diligence process and the Chinese walls in advisory firms provide two examples.

10 The transaction focus creates an incentive for a party to a transaction to pocket the proceeds with an insider if it goes well and 'renege' by threatening to bring an insider trading transaction if it goes badly. Major shareholders may no longer enjoy contractual security.

11 The 1995 book *Payback: The Conspiracy to Destroy Michael Milken and his Financial Revolution* by Professor Daniel Fischel of the University of Chicago economics department illustrates these issues.

- ***Problem identification*** No objective evidence is provided that concerns about insider trading are widespread. No particular incidents are cited. No distinction is made between informed assessments of the issue and populist beliefs or lay impressions. Instead a list of costs to private action is provided.

- ***Policy objective*** The assertion is made that insider trading laws are crucial in promoting the market to small investors and in determining how overseas investors view the New Zealand market. However, ownership of the New Zealand market by small investors was probably far higher when New Zealand had no insider trading legislation (for unrelated reasons). Furthermore, the large portion of the New Zealand sharemarket now owned by overseas investors surely rebuts the claim that further regulation is crucial.

- ***Consideration of alternatives*** No consideration is given to alternative ways of promoting the market to investors – such as those relating to increasing New Zealand's economic growth prospects, or even to scrapping this ill-designed piece of legislation.

- ***Net benefits*** All the proposals seem likely to increase legal expenses and other costs. Some would increase the scope for opportunistic private actions by shifting the costs away from the opportunistic party on to innocent parties. Greater enforcement should deter both desirable and undesirable uses of price-sensitive information. The relative balance depends on how much undesirable insider trading there is in reality. We do not believe that it is high, but are open to evidence on this matter. On the other hand, there is a daily need for companies to be able to use price-sensitive information flexibly and sensitively and to be able to contract with confidence. These perspectives incline us to the view that the net benefits are strongly negative.

*5.7* We favour a complete review of the entire legislation. In our view no amount of tinkering with it will prove satisfactory, but considerable damage is possible. The review should not be undertaken by the Securities Commission which is responsible for the present legislative mess. Until this

review is undertaken the law may be best left as it is. New Zealand should try to avoid schemes that encourage excessive and opportunistic litigation. It will benefit lawyers, but this is not necessarily a national benefit.

5.8 The Paper also asks for comments as to who should fund the projected greater expenses of enforcement. In our view, public goods of a national interest nature are best funded from general taxation. As a general rule, those who initiate private actions should bear the costs. Given the scope for opportunistic, anti-competitive and mischevious litigation, it may be particularly important to ensure that they are exposed to the risks of having all costs awarded against them. Finally, if a club good model is adopted for funding purposes, in principle the members of the club should determine the quantum of the activity. Further, membership of the club should be voluntary. If membership, or the level of subscriptions, is to be mandatory it is likely that the service is really a public good.

## 6.0 Consolidation of legislation and regulatory bodies

6.1 We agree with the Paper that there is a real concern about the problem of scarce expertise in New Zealand. However, in our view the scarcity is most severe in respect of public policy advice and analysis. Far too many regulatory proposals in New Zealand fail to pass the basic hurdles of problem definition, statement of objective, identification of alternatives and demonstration of net benefits. All too often the approach is simply to put forward a narrow set of solutions to a perceived problem. In our view, organisations that are weak in the technical areas of economics, law and economics, and the theory of finance are also likely to be very weak in the design of public policy. The Securities Commission has been notably weak analytically, as New Zealand's experience with insider trading legislation and the takeover debate demonstrate, but it is not the only one.

6.2 In our view, consolidation may or may not bring gains. A monolithic regulator could be worse than competing regulators that allow society to experiment in less costly ways when they take different approaches. However, neither approach addresses the fundamental problem of the unsatisfactory nature of much of our legislation and the absence of effective checks and balances on the quality of new legislation.

6.3 In our view no changes should be made without much more detailed analysis.

## 7 Concluding remarks

7.1 Labour's goal is to promote investor confidence. We agree that quality regulation should assist in the achievement of this goal. Quality regulation arises either from chance or from good quality analysis. Most investors would be unnerved if they knew quality regulation could only occur by chance under Labour. Therefore their confidence about future regulation will depend, at least in part, on the quality of the analysis provided in support of Labour's regulatory proposals, both in general and in any particular case.

7.2 The proposals in the Paper give the unfortunate impression that Labour will base its regulatory proposals on narrowly conceived responses to ill-defined problems, such as the problem of 'investor confidence'. We strongly commend Labour to make less use of populist arguments and much greater use of professional analyses drawing on finance theory, public choice theory and law and economics.

7.3 Fund managers and major investment banking firms and the professional staff in major companies tend to have a high level of expertise in finance. Naïve financial theories are particularly likely to reduce their level of confidence. As the above discussion illustrates, the populist arguments put forward by 'small shareholder advocates' have been particularly weak from a finance theory perspective. Indeed, there is a long list of professors in finance who have questioned aspects of these regulations, and it is difficult to think of any who have been supporters.

7.4 We strongly commend Labour not to proceed with proposals that do not attract the support of leading analysts in the fields we have mentioned.

7.5 We note the view expressed in the Paper's opening remarks that Labour believes there is greater scope for more public education about the nature and function of the sharemarket. In our view, the New Zealand Stock Exchange does a good job in this area, but it should be left to its members to decide its spending priorities. The government has a role to play. Critical

messages that the government needs to give are that investments are risky, that high return means high risk, and that governments cannot make investments safe for investors. The government must concern itself with the effectiveness of laws against fraud and coercion, but fraudulent schemes and fraudsters are part of the human condition that governments cannot eliminate; they can merely reduce their prevalence. Governments should tell investors, over and over again, that 'buyer beware' is their best maxim. What governments should not be doing, and have done all too often in the past, is make irresponsible statements likely to undermine the reputation of the New Zealand market in the eyes of the world – for example, proclaiming to the world that New Zealand is "the last frontier of the Wild West". New Zealand's commercial laws have always been based on English law and are not out of line with good international practice. Problems that emerge should be addressed wisely and expeditiously.

7.6 Finally, we applaud the comment on page 3 of the Paper that Labour recognises that these are complex and technical issues and will take a careful approach "in full consultation with the finance and investment industries". In this context, we draw Labour's attention to the Ministry of Commerce's 3 May 1999 summary of opinions on these and related matters at the Business Law Forum it held in March this year. We attach a copy of this summary and stress that it is a summary of the views of a substantial business forum, not of the Ministry of Commerce. However, it may provide Labour with a useful guide as to the views of a professional group drawn together to advise on business law priorities.

7.7 A recurring theme in this summary is concern about the excessive costs and uncertainties arising from existing securities regulation. Regulations are outdated, do not take modern business practices into account, and overlap unsatisfactorily. The summary questions the basis of existing insider trading law and the uncertainties that surround its provisions. It refers particularly to the uncertainty it creates for pre-prospectus publicity. Enforcement is also questioned. The summary draws, at paragraph 54, the unequivocal conclusion that:

> A general review of the Securities Act should be undertaken, including the question of its application to secondary markets.

An equally clear conclusion emerged about the takeover code (paragraph 59):

> The significant number of takeovers indicates that the voluntary regime appears to be working well. "The code should be buried for good".

7.8 Public sector resources capable of handling these issues are scarce. The parliamentary legislative timetable is also usually a constraint. We do not believe that any credible case can be made that the weight of professional opinion in the finance and investment community would see implementing a takeover code as a priority. Nor should Labour simply address issues of enforcement of insider trading laws when it is abundantly clear that the law itself needs a fundamental review.