Financial System Inquiry Interim Report (July 2014)

Submission by

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We write as two university academics active in research and teaching in the area of the regulation of financial systems and financial services to make the following second round submission on the issue of disclosure, based on our forthcoming book *Promoting Information in the Marketplace for Financial Services – Financial Market Regulation and International Standards* (ISBN 978-3-319-09458-9, Springer, Berlin, Germany, 2014) (further details in the Appendix below).

Summary

Our submission is based on our research into the reasons for the failures of financial system regulation to ensure and to promote the disclosure of information in the financial system. We have concluded that the financial system remains uninformed, as evidenced by the new disclosure laws continually being passed to cure the problem of non-disclosure which is always revealed by investigations and inquiries by regulators (government) after every 'boom' and 'bust'. We have identified the costs of collection, dissemination and compliance with myriad and overlapping disclosure laws as the first reason for the failure to produce information. We argue that the second reason for the failure to produce information is management's conflict of interest in what information to disclose and how to disclose it. The result is that stakeholders in the financial system remain uninformed. The third reason for non-disclosure is the absence of a method to actually ensure disclosure. We argue that the financial system remains uninformed despite the best of intentions of government with their continual passing of new disclosure laws and the efforts of regulators such as the Australian Securities and Investments Commission (ASIC). We recommend a return to effective coregulation by regulators such as ASIC with SROs in the financial system (self regulatory organisations) such as stock exchanges, underpinned by a simple principles-based standard like 'you must keep the financial market fully informed'.

(1) Background: regulation of disclosure

The regulation of disclosure is designed to redress alleged or potential market failure to provide information to protect stakeholder interests in the financial system by ensuring and promoting improved economic performance in the form of meaningful and material disclosure. It recognises that stakeholders will be protected when they receive transactions of the highest quality which can be produced at the price they are willing to pay.[1] Hence, the purpose of disclosure regulation, like any legislation to correct market failure, can be justified on equitable and economic grounds. 'Equitable grounds' include fairness and fair access to information. Any economic justification rests on the proposition that inadequate levels of disclosure can lead to loss of investor confidence in the market and withdrawal of investment.

Against this background, our research set out in our book has examined and has sought to understand the reasons driving the reluctance of, for example, the financial services industry to coregulate effectively with regulator and stock exchange to ensure disclosure of information in the financial system.

(a) Disclosure – the first problem – cost of dissemination

This submission has asked what is the most effective way to promote the disclosure of information in the financial system to ensure that stakeholders are fully informed? Our research has identified the first problem which is likely to impede the use of disclosure as the cost of the collection of information and the dissemination of the information. Producing information is not cost free, and disclosure is not costless. Information is a private good, not a public good, and it is produced at a cost. The market produces the amount of information (the outcome) that maximises social welfare. The market supplies information at the point where its marginal cost of producing the information equals the stakeholder's marginal benefit in receiving it. The private costs involved in disclosure may exceed its social cost, and lead to a reduction in disclosure. A competitive private market will not produce the optimal amount of the good, and will tend to underproduce information. 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.

(b) Disclosure – the second problem – conflict of interest

Our research has identified the second problem of disclosure – that those under a duty of disclosure face conflicts of interest in what and how they will disclose information. Management and users have different needs regarding disclosure. For reasons of self-interest, management will want to release good news. Current disclosure laws contain inadequate incentives to disclose beyond the sanctions spread over the many different areas of law examined in this submission. Information must be available, and stakeholders must have access to it and must be able to understand it. Our research has identified the loss of competitive edge as a further reason for non-disclosure. It has shown that disclosure does put management at legal or other risk, and that management is rightly concerned about the legal implications of disclosure.

The decision to disclose information in response to regulation (in the form of legislation, case law, regulator and stock exchange rules) may present management with conflicts of interest between their self-interest and the demands of stakeholders. Disclosure by management will

[1] See, eg, Daniel Fischel and Sanford Grossman, Customer Protection in Futures and Securities Markets (1984) 4 *Journal of Futures Markets* 273.

follow form over substance at the lowest level of disclosure. Management will naturally not provide negative information about their competence and performance on grounds including self-protection, the maintenance of confidentiality and not giving away a competitive edge. Management is most likely to voluntarily disclose good information and self-serving information if and when there is a risk of being caught out, a disclosure which will limit the divergence of interests between management (principal) and investors (agent).

There is a further limitation on disclosure and the form it takes due to another level of self-interest. Disclosure often starts with accountants, who will insist that only they are qualified to prepare accounts. Further, there is little role for independent auditors in disclosure, as they will have 'bought' – in Stigler's terms – a system of auditor registration designed to maintain auditor standards. These standard will also keep out other potential auditors such as bankers, financial analysts and investment banks who may be considered unqualified, yet independent.

(c) Disclosure – the third problem – complicated disclosure regime

Our research has answered the third problem – how exactly to promote information in the financial system – with some simple suggestions for disclosure building on the current different approaches to disclosure. It has recommended supporting the role of SROs like the stock exchanges in their rules and expectations of high ethical standards, support which would come from coregulation with the regulator as the shotgun behind the door.[2] It has recommended a principles-based harmonised and rationalised principle of continuous disclosure with an ethical tone to ensure a more consistent approach to non-disclosure. There is merit in simple disclosure, backed up with laws against some of the undesirable practices which gave rise to allegations of non-disclosure.[3] The principle would establish (confirm) the expectation of disclosure as an overriding principle of financial market regulation.

Taken together, these three problems have motivated us to propose a new simple plain English approach to disclosure that can be formalised as a new working model for financial system regulation.

(2) Disclosure regulation is not working

We acknowledge that Australia's regulatory framework relies heavily on disclosure to protect and empower stakeholders such as investors and consumers, and we understand that submissions support a view that the disclosure framework is not achieving its objectives (Inquiry para 1-20).

We argue that despite the best of intentions and the continuing efforts of governments with the continual passing of new disclosure laws, the regulation of financial systems fails to achieve full, meaningful and material disclosure. Our research confirms the Inquiry's comment that the current disclosure regime produces complex and lengthy documents that do not always enhance consumers' understanding of financial products and services (Inquiry paras 1-20, 3-56)

The efficient operation of the financial system is dependent on disclosure and that less disclosure results in less informed and therefore a less efficient financial system. Disclosure regulation continues to demonstrate the triumph of form over substance over its many

[2] William O. Douglas, *Democracy and Finance* (Yale University Press, 1940) 82.

[3] See, eg, Omri Ben-Shahar and Carl Schneider, The Failure of Mandated Disclosure (John M Olin Law and Economics Working Paper No 516, 2d series), *University of Chicago Law School* (2010) 62-66.

disparate and piecemeal laws. The failure of effective disclosure laws affects the integrity of the financial system and leaves it operating partly in the dark.

Globally, disclosure regulation is based on an expanding number of laws – in the form of legislation, rules and regulations made under legislation, case law, equitable remedies and soft law in the form of releases, rules and regulation guides of ASIC (government) and SROs (self regulatory organisations like industry associations and stock exchanges) – which require disclosure. Despite these, financial system disclosure law is disparate, piecemeal, incomplete and has many exceptions, carve-outs and limitations (sometimes reflecting the power of the lobby groups).

We have concluded that the present state of disclosure law does not achieve disclosure for stakeholders (including companies, consumers, creditors, employees, investors, shareholders and regulators [governments and commissions]). Those in the financial system and financial markets remain uninformed. Disclosure is distorted with nondisclosure in the form of, for example, misleading or deceptive conduct, rumours, market manipulation and insider trading.

We start with the quotation from Louis D. Brandeis, later of the US Supreme Court, that 'Sunlight is said to be the best of disinfectants; electric light the most efficient policeman'.[4] We argue that the failure of voluntary disclosure is obvious for the simple reason of self-interest. We acknowledge some success of mandatory disclosure – in the absence of workable alternatives – to enhance the credibility of information to overcome market failure. We ask if there are any lessons to be learned from the fact that sometimes firms do voluntarily disclose bad news – so that they can control its release on terms favourable to themselves. We have studied the contrast between mandatory disclosure with voluntary disclosure, and concluded that mandatory disclosure (in particular, mandatory continuous periodic disclosure) has the effect of some enhancement of the credibility of information to overcome market failure.

We present a framework for the regulation of the financial system including financial markets. We argue that current disclosure regulation is unfair to stakeholders (including shareholders and investors, regulators including ASIC) who fall between the regulation gap – what they thought disclosure law would deliver, and what it actually does deliver.

As a result of our research into the common law and civil law rules on financial system disclosure and the requirement of fair dealing by financial system intermediaries as a source of disclosure to the financial system, we argue that full and consistent disclosure cannot be expected at common law from any implied term of the contract of good faith and disclosure. We conclude that the fundamental fiduciary principle of agency law of good faith and disclosure cannot in itself be relied on to produce information. In several civil law jurisdictions, the principle of good faith can be a basis for disclosure obligations. However, these obligations remain piecemeal and can only complement the statutory roles on broker disclosure. Further, we have concluded that the economic loyalty owed by agent to principal will not ensure disclosure from agent (broker) to principal (client).

We argue that industry licensing has potential as a means of ensuring disclosure, but we have concluded that industry licensing cannot be relied on as the only authority for disclosure. We have examined occupational licensing schemes in industries and professions designed inter alia to maintain standards of qualification and expertise. We do support the administrative practice of ASIC to use the obligations of the financial services licensee to provide financial services 'efficiently, honestly and fairly' but that this is not the only way to ensure effective disclosure by coregulation with ASIC.

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[4] Louis D. Brandeis, *Other People's Money, and How the Bankers Use It* (Frederick A Stokes, New York, 1914, reprinted 1986) chapter 5 (What publicity can do) 92.

We have researched the role and the effectiveness of regulators such as ASIC as authorities for disclosure under the IOSCO (the International Organization of Securities Commissions, based in Madrid) template. (Under the IOSCO template, a regulator is like a mini-government acting across the separation of powers – it is executive/administration, de facto legislature (issuing regulatory guides and other notices) and adjudicator/decision maker.) We have demonstrated that regulation of disclosure by the regulator alone is not as effective as the regulation of disclosure by a regulator when balanced with coregulation by authorities in the financial system such as the stock exchanges. Government regulation has many shortcomings such as distance from the market (in location and in experience), and potential overreliance on administrative and managerial procedures (bureaucracy, caution, delay). By definition, regulators like ASIC are outsiders with many lawyers and regulators on staff instead of industry participants with experience in the market such as former and experienced brokers and finance professionals.

We do support the role of authorities in the financial system such as industry associations and stock exchanges as self-regulators to ensure disclosure to the financial system, but only when supported with coregulation with regulators like ASIC. These have expertise, experience and knowledge of the self-regulation rules which they wrote in response to issues which they identified and understood. We support the strong endorsement of co-regulation by Oladele and Ogunleye that the sharing of regulatory scope by stock exchanges (self-regulatory organisations - SROs) in the financial services sector and government (regulators) offers a 'symbiotic regulatory framework' that enables the government to control risks to investors that SROs are ill positioned to reach'.[5] We have studied the failure of stock exchange self-regulation due to self-interest and interaction with networks of business associates (buddies) – and contrasted its improvement with regulator and government intervention as coregulation with the regulator's shotgun behind the door. There is scope for the enforcement of disclosure under stock exchange operating rules, especially by means of their enforcement by the regulator, the stock exchange or by relevant third persons with standing.

(3) In support of principles-based regulation for disclosure in the financial system

The Inquiry is aware that disclosure obligations can arise under various laws – securities regulation, broker/client and financial intermediaries' law (including licence conditions), stock exchange rules, contract law, corporate law and even competition law. The overlaps result in disparate piecemeal regulation, and as a result, the number of disclosure rules in the financial system is still growing. The comment of Colliton with reference to tax regulation unfortunately applies equally to financial system regulation:

> The (US) Internal Revenue Code has grown steadily and inexorably since its very beginning… It is difficult to avoid comparing the tax law to a cancer, slowly devouring the patient.[6]

The problem underlying this regulatory patchwork is the lack of an overarching principle to promote the disclosure of information in the financial system. We recommend a total rethink of financial regulation following the underperformance of the existing disclosure regulation. A simple structural reform could reduce the principles of disclosure back to a plain English statement of principle – like simple tax laws – to set out the basic duty of accountability based on enhanced disclosure and transparency owed to clients by those in the financial

[5] O.O. Oladele and T.A. Ogunleye, The Conceptual Basis and Limit of Self-regulation by Securities Markets in Nigeria and the United States (2006) 3 *University of Botswana Law Journal* 45, 50.

[6] James Colliton, Standards, Rules and the Decline of Courts in the Law of Taxation (1995) 99 *Dickinson Law Review* 265, 328 (pointing out how US federal tax legislation has grown from the original 16 pages in 1913).

services business. Such a principle for the financial system is intended to be sufficiently general to be applicable to new situations which arise in response to developments in the rapidly changing financial sector. This would provide a plain English standard of conduct built on business integrity to underlie the provision of financial services.

The discussion around rules versus principles of conduct could be confusing, as rules are needed to give rise to principles, and principles are the result of rules. The typical example of the difference between rules and principles relates to speed limits. A sign showing a speed limit of 60 kph is a rule, whereas a sign stating 'Do not drive faster than is reasonable and prudent in all the circumstances' is a principle.[7] The example demonstrates the advantages and disadvantages of rules and principles. For example, there is nothing ambiguous about the rule 'Speed limit 60 kph', but its application to the facts (that is, the actual speed) is always under challenge in court. Moreover, the rule does not take into account that in some situations a speed of 60 kph might be unreasonable - for example if there are unexpected bad road conditions. In comparison, 'Do not drive faster than is reasonable and prudent in all the circumstances' is a principle with much potential for subjective interpretation. The application of principles includes flexibility in how the principles apply to different cases, but it may take time and effort to apply the principle to a situation. Nowadays, principles-based and outcome-based regulation is an important part of regulatory design.[8]

There is no straight dichotomy of rules and principles (sometimes referred to as standards). Creating a principles-based regulatory environment without any rules will probably be impossible while rules typically allow discretion and interpretation. Principles and rules also influence each other. Rules will become standards and standards will become rules if they collapse together. Rule makers who try to create an environment of discretion may be frustrated by the courts and the legal process. Schauer predicts that heuristics will be used to curb discretions and sharp-edge rules will be rounded.[9] Thus it is inaccurate to refer to rule-based or principle-based regulation. The right question is whether regulation is *more* principles-based or more rule-based.

(4) Principles-Based Regulation in the Financial System

(a) Advantages of principles-based regulation

The idea of more principles-based regulation can be applied to the regulation of the financial system. The debate originated in relation to accounting practices after the fall of Enron[10] and then moved towards corporate and financial markets law. Financial system regulation can be principles-based or rules-based. For example, some jurisdictions impose a duty to act

[7] Christie Ford, New Governance, Compliance and Principles-based Securities Regulation (2007) 45 *American Business Law Journal* 1, 6.

[8] Ian Ayres and John Braithwaite, *Responsive Regulation: Transcending the Regulation Debate* (Oxford University Press, Oxford, 1992). There is a vast body of literature on the rule/principle dichotomy, see, eg, Frederick Schauer, The Tyranny of Choice and the Rulification of Standards (2005) 14 *Journal of Contemporary Legal Issues* 803; Pierre Schlag, Rules and Standards (1985) 33 *UCLA Raw Review* 379; Ford, above n 7; Colliton, above n 6; Russell Korobkin, Behavioral Analysis and Legal Form: Rules vs. Standards Revisited (2000) 79 *Oregon Law Review* 23.

[9] Frederick Schauer, The Convergence of Rules and Standards [2003] *New Zealand Law Review* 303.

[10] See, eg, William Bratton, Enron, Sarbanes-Oxley and Accounting: Rules Versus Principles Versus Rents (2003) 48 *Villanova Law Review* 1023.

efficiently, honestly and fairly on financial intermediaries and similar obligations on the operators of financial markets to provide overarching principles for market conduct.

Nowadays regulators in several leading financial marketplaces apply principles-based regulation to some extent, as discussed below. It is important to understand that principles-based regulation is not the same as self-regulation. The latter refers to the degree of public intervention in the private sector while the former is a particular regulatory approach that may or may not be highly interventionist.[11] However, both principles should be applied simultaneously: lawmakers and regulators should set out overarching principles, and they should leave market participants to find the most efficient way to achieve the outcome.[12]

What is needed is to focus regulation on clearly enunciated regulation principles which do not need a detailed set of interventionist rules for effective implementation so that regulatory preference is given to principles-based over rules.[13] The theoretical advantage of this approach is that, in contrast to a strictly rule-based approach, the regulator (commission, government, SRO) would not be limited to the factual issues but could specify what conduct is allowed or prohibited.[14] This would provide flexibility because the principles-based regulation would be set out in general and unspecific terms to cover whatever may arise in the future such as new financial products. For example, recent events in New Zealand again demonstrate the lack of flexibility of rules-based regulation. The New Zealand government implemented new prescriptive rules in 2010 to restrain unsolicited offers into the draft for a new financial markets framework after a number of unsolicited ('low-ball') offers on dubious investment vehicles had been made to private investors.[15] Although the changes were made promptly and in great haste, almost one year passed before the regulator had the proper tools in place to address these dubious investments. Under a more principles-based regime, the regulator should have been able to act earlier.

The absence of a principled-based disclosure standard for disclosure can result in technicalities and arbitrary distinctions, expensive test cases, reliance on arguments of equity, history or policy, and may result in the hasty passing of disparate and piecemeal legislation by different generations of legislators often for political reasons with a short time-frame in response to booms and busts.[16] A principle-based approach aims to overcome avoidance of disclosure and loopholing of disclosure regulation, and an unthinking 'tick the box' approach to compliance.[17] Principles would derive from market forces as they set a broad framework

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[11] Christie Ford, Principles-Based Regulation in the Wake of the Global Financial Crisis (2010) 55 *McGill Law Journal* 257, 284.

[12] Julia Black, *The Development of Risk Based Regulation in Financial Services: Canada, the UK and Australia – A Research Report* (ESRC Centre for the Analysis of Risk and Regulation, London School of Economics, 2004) 30.

[13] This supports the recommendation of the Task Force to Modernize Securities Legislation in Canada, *Canada Steps Up*, Final Report (Government of Ontario, Toronto, 2006) 50.

[14] Louis Kaplow, Rules versus Standards: An Economic Analysis (1992) 42 *Duke Law Journal* 557, 559.

[15] See Philipp Maume and Gordon Walker, Goodbye to All That: A New Financial Markets Authority for New Zealand (2011) 29 *Company and Securities Law Journal* 239, 243.

[16] Jason Neyers, Canadian Corporate Law, Veil-Piercing and the Private Law Model Corporation (2000) 50 *University of Toronto Law Journal* 173, 177-178.

[17] See, eg, Joanna Benjamin, *Financial Law* (Oxford University Press, 2007) para 27.32; Fabian Walla, Process and Strategies of Capital Markets Regulation in Europe, in: Rüdiger Veil (ed), *European Capital Markets Law* (Hart Publishing, Oxford, 2013) 43.

of conduct and expectations within which the financial services industry acts. Principles-based regulation can give effect to the fiduciary principle of the economic loyalty of a broker to its client and the standards of competence and skill laid down by statutes, cases, self-regulatory organisation (SRO, like stock exchanges) operating rules.

The purpose of adopting a more principles-based approach to disclosure regulation is to build an environment of good faith – designed to be less technical than what can be achieved by passing more legislation – to achieve a better outcome for clients, investors and the financial system. Principles provide 'a rational, systematic alternative to an unscripted layering-on of rules on rules to deal with each new situation and their corresponding adverse system effects'.[18] The appropriate principles would be drafted to ensure that firms treat their customers fairly in all parts of their business and to minimise the scope for loopholing of disclosure rules.

In any discussion of the principles of investment business in any legal jurisdiction, the contractual duties owed by firm to client (fiduciary, good faith) are paramount. Plain English principles are a good precedent, but they must not detract from existing fiduciary duties. To uphold standards of conduct, these breaches would be actionable by the enforcing body such as the stock exchange in disciplinary proceedings and also by private investor action.

Another advantage of a simple language 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 other countries, which would enable an internationally coherent application of disclosure obligations. A good example is the duty to act 'efficiently, honestly and fairly'.

(b) Disadvantages of principles-based regulation

The main disadvantage of principles-based regulation is that it may lack certainty. It must be possible for the regulated to predict, at the time of decision making, whether or not the decision would or would not be a breach of a principle. Thus, the lack of certainty is actually a lack of predictability.[19] Lack of certainty can go hand in hand with a potential lack of transparency, and the flexible approach might be in conflict with fundamental legal principles such as certainty and legal clarity. This is critical if penalties are based on the sole basis of principles developed by the regulator.[20]

These arguments do not discredit principles-based regulation as such. Whether principles are certain (predictable) depends on the extent to which there is a shared understanding as to their meaning and application between regulators and regulated.[21] It is our view that principles-based regulation should be supported by coregulation by regulators like ASIC and SROs. The overarching principles should be set out by statute law, while SROs have the power to create rules for members based upon the principles (for example, the business and listing rules of stock exchanges). The role of the regulator would be to make sure that the market rules are in line with the principles, that the desirable outcomes are achieved, and that the rules cover all

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[18] Ford, above n 7, 60.

[19] Julia Black, Martyn Hopper and Christa Band, Making a Success of Principles-Based Regulation [2007] *Law and Financial Markets Review* 191, 196-197.

[20] Walla, above n 17, at 42.

[21] Black et al, above n 19, at 194.

relevant areas of the financial system. This would be facilitated by a responsive approach to regulation.[22]

Lack of clarity would only be an issue if disclosure regulation relied solely on principles. Instead, we would envisage support of principles-based regulation by coregulation by the regulator with the shotgun behind the door - for example, by the imposition of penalties. Penalties could be set out in stock exchange listing rules. Licence revocation could result from a breach of the duty to act efficiently, honestly and fairly. In short, principles-based regulation would primarily focus on day-to-day conduct, including the best way to disclose information to the financial system, with the fall back to statute law for law enforcement.

(5) Examples of principles-based regulation in financial markets

(a) Principles for Business (United Kingdom)

There is a good track record of principles-based regulation in the United Kingdom, where detailed, verbose, prescriptive and expanding rules-based regulation set out in rulebooks has been trimmed down to short, practical and easily-understood principles for business.[23] The move of the original financial services regulator in 1990 towards a more principles-based approach to principles for business, now carried forward by the Financial Conduct Authority (FCA), was a landmark in financial markets regulation. The overarching Principles for Business of the Financial Conduct Authority[24] – eleven fundamental obligations of firms under the regulatory system which include integrity, and skill, care and diligence, provide 'light-touch' financial regulation with powerful messages behind simple statements. They do not weaken consumer protection. The Principles for Business overlap the Shingle Theory in the United States[25] and the duty of care commensurate with professional responsibilities[26] in promoting proper standards of market conduct. In some areas – such as in insider trading – much of the enforcement activity of the former Financial Service Authority (FSA) was based on the breach of principles.[27]

There was evidence that the regulated preferred the principles-based approach, and, for example, executive staff members of the London Stock exchange stated that the flexible principles-based regime was a major reason for a significant shift of initial public offerings

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[22] The concept of 'responsive regulation' assumes that regulators will never have the resources to prevent or remedy all breaches of the law. Thus, the commission's (regulator's) actions should be responsive to the behaviour of the regulated, and the regulator should try to motivate the regulated to comply with the law on his or her own. See, eg, Ian Ayres and John Braithwaite, Responsive Regulation: Transcending the Deregulation Debate (Oxford University Press, 1992).

[23] Other countries were far more reluctant to introduce a principles-based approach to financial markets regulation. For Europe, see Walla, above n 17, at 42.

[24] Financial Conduct Authority, *FCA Handbook* (London, 2014). http://www.fca.org.uk. These carry forward the fundamental obligations of all firms under the regulatory system from the earlier SIB *Proposed Principles for Investment Business* (1990), made by the SIB under the authority of the former *Financial Services Act 1986* (UK) s 48.

[25] For discussion of the Shingle Theory, see, eg, Roberta Karmel, Is the Shingle Theory Dead? (1995) 52 *Washington and Lee Law Review* 1271 (Karmel answers in the negative).

[26] See, eg, *Medddick and Meddick v Cutten and Harvey* (1984) 36 SASR 542, 556; Department of Trade and Industry, *Financial Services in the United Kingdom – A New Framework for Investor Protection* (1985) 20.

[27] Walla, above n 17, at 41.

from New York to London.[28] For example, the former FSA had confirmed the importance of firms under the regulatory system paying due regard to the interests of their customers and treating them fairly. They must pay due regard to the information needs of their clients, and communicate information to them in a way which is ‘clear, fair and not misleading’. They must manage conflicts of interest fairly, both between themselves and their customers and between client and client. They must pay due regard to the interests of their clients and they must treat them fairly. The FSA could not have been clearer when it stated that ‘consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale’.[29]

(b) Regulation Fair Disclosure (United States)

Traditionally, the United States apply a regulatory approach which leans towards the rule-based approach. However, there are principles-based equivalents by the Securities and Exchange Commission (SEC) and by other regulators.[30] A good example is the Regulation Fair Disclosure (Reg FD), a simple rule passed by the SEC in 2000, also set out in Plain English:

> ‘Whenever an issuer, or any person acting on its behalf, discloses any material nonpublic information regarding that issuer or its securities to [certain enumerated persons], the issuer shall make public disclosure of that information... simultaneously, in the case of an intentional disclosure; and... promptly, in the case of a non-intentional disclosure.’

In the words of the SEC, Reg FD is designed to promote the full and fair disclosure of information by issuers including bringing to an end the selective disclosure of material nonpublic information by issuers.[31] By favouring institutional investors over retail investors, selective disclosure ensured that all investors were not equal because all investors did not have equal access to corporate information. Reg FD has now ensured more and better corporate communication – whether by social media, press releases, conference calls or websites – resulting in more transparency. There is academic research that Reg FD has achieved its purpose of lowering return volatility by prohibiting private communications by analysts and firms around earnings announcements especially for the median or typical firms.[32]

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[28] See Ford, above n 7, at 1-2.

[29] Financial Services Authority (UK), *Treating Customers Fairly – Towards Fair Outcomes for Consumers* (2006). http://www.fsa.gov.uk/pubs/other/tcf_towards.pdf. Accessed 25 August 2014; see, eg, Clive Briault, More Principles-based Regulation and Treating Customers Fairly, FSA Summer School (2006) and ASIC Summer School (2007). http://www.fsa.gov.uk/pages/Library/Communication/Speeches/2007/0307_cb.shtml. Accessed 25 August 2014.

[30] This approach was being looked at in Canada in British Columbia’s Bill 38-2004 Securities Act, which had a principles-based and outcome-oriented regulation. It was passed in 2004, but shelved while the current province and territory national ‘passport system’ was developed: Ford, above n 7.

[31] Reg FD also targets when insider trading liability arises in connection with a trader's ‘use’ or ‘knowing possession’ of material nonpublic information, and when the breach of a family or other non-business relationship may give rise to liability under the misappropriation theory of insider trading: Securities and Exchange Commission, Final Rule, Selective Disclosure and Insider Trading, 17 CFR Parts 240, 243, and 249; Release Nos. 33-7881, 34-43154, IC-24599; File No. S7-31-99, RIN 3235-AH82. http://www.sec.gov/rules/final/33-7881.htm.

[32] Frank Heflin, K.R. Subramanyam and Yang Zhang, Regulation FD and the Financial Information Environment (2003) 78 *Accounting Review* 1.

However, the full disclosure required by Reg FD has reduced the demand for analysts and their services to the extent that some now say that the reduction in analysis and tips by analysts has reduced full disclosure. Critics of Reg FD argue that it does not recognise the importance of private communication to and from analysts as an important source of material information. There is some evidence that post Reg FD earnings forecasts are now less accurate, and as a result there has been a reduction in both selective guidance and the quality of analyst forecasts.[33]

There is further evidence that post-Reg FD, analysts who had preferential links with firms that they covered - such as analysts from large brokerage houses who used to tend to have greater forecast accuracy pre-Reg FD - are now unable to sustain their forecasting superiority. This evidence suggests that Reg FD has levelled the information playing field among analysts and that it now requires more effort by analysts to arrive at forecasts – 'idiosyncratic information discovery' - on part of the financial analysts, independent of disclosures by managers of firms that they cover.[34]

(c) Good Disclosure Principles (Australia)

We support the view of the Inquiry that the current disclosure regime produces complex and lengthy documents that often do not enhance consumer understanding of financial products and services (3-49.) In this submission, we recommend a principles-based approach for a simple disclosure principle with an ethical tone. In this vein, ASIC has set out its disclosure principles for standard disclosure documents in its Good Disclosure Principles:

1. Disclosure should be timely.
2. Disclosure should be relevant and complete.
3. Disclosure should promote product understanding.
4. Disclosure should promote comparison.
5. Disclosure should highlight important information.
6. Disclosure should have regard to consumers' needs.[35]

To add to the principles of 'good disclosure', ASIC has stated that it expects the information in the standard disclosure documents to comply with statute law, and it has reminded the financial services sector of the requirement in corporate law that the disclosure documents must be 'clear, concise and effective'.[36] This means that the standard form disclosure documents must be helpful to consumers: 'ASIC sees disclosure under the new law as a consumer-centric regime, focussing (sic) on the consumer's information needs'.[37] The

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[33] Anup Agrawal, Mark A. Chen and Sahiba Chadha, Who is Afraid of Reg FD? The Behavior and Performance of Sell-Side Analysts Following the SEC's Fair Disclosure Rules (2006) 79 *Journal of Business* 2811.

[34] Partha Mohanram and Shyam Sunder, How Has Regulation Fair Disclosure Affected the Operations of Financial Analysts? (2006) 23 *Contemporary Accounting Research* 491.

[35] These relate to product disclosure statements issued by financial service licensees as required by Pt 7.9 of the *Corporations Act 2001* (Cth). ASIC, *Disclosure: Product Disclosure Statements (and other disclosure obligations)* (Australian Securities and Investments Commission, Regulatory Guide 168, Sydney, 2001) RG168.10.

[36] As required by *Corporations Act 2001* (Cth) s 1013C(3).

[37] Financial Services Reform disclosure to be clear, concise and effective (ASIC Media Release 04-062, 10 March 2004).

approach taken by ASIC is remarkable because it is in stark contrast to Australia's otherwise highly prescriptive approach to securities regulation.

(6) Principles-Based Regulation and the Global Financial Crisis

The Global Financial Crisis of 2007/2008 (GFC) prompted consideration of reform of the financial system, including the relevance and the role of principles-based regulation.

Principles-based regulation is often perceived as a form of light-touch regulation. It is important in the context of the failure of regulation, a failure which has been accepted as one of the reasons for the GFC stock market crash and the credit crunch. The FSA – an important proponent for principles-based regulation – was restructured due to perceived flaws in its regulatory approach during the GFC, but its principles-based approach continues.

As discussed in this submission, regulatory failure occurs in various areas of regulation. This includes, inter alia, understaffed and passive regulators, a rapid evolution of complex financial products resulting in opaqueness in de-facto deregulation, gaps in the regulatory framework, the increasing interconnectedness of financial markets, and a blurring of boundaries between banking, insurance and securities markets. None of this implies a failure of principles-based regulation. Most of the risky investment vehicles which triggered the GFC were traded over-the-counter and were thus not – or to a low extent – subject to regulation. Similarly, the shadow banking system was not subject to prudential regulation. However, principles-based regulation is about drafting regulation in a particular way; it should not be confused with the absence of regulation. Let us remember that the GFC originated in the United States, not in the United Kingdom.

The restructure of the FSA does not imply failure of the principles-based approach. Generally regulatory systems which are traditionally more rule-based than principles-based (such as the United States) fared no better than did the FSA's principles-based approach during the GFC. The main problems which emerged in the United Kingdom as a result of the GFC did not result from principles-based regulation, but from the failure of banking supervision and the misbelief that markets were generally self-correcting, and that market discipline alone could be trusted to contain risks.[38] Consequently the FCA has carried forward the principles-based approach as it had been developed by its predecessor, the FSA. However, there is no question that the GFC emphasised the need for well-funded regulators and a vigorous approach to enforcement.

(7) 'You Must Keep the Financial Market Fully Informed'

This submission supports moves in the United States for principles-based regulation as an alternative to detailed rulebooks to include 'overarching regulatory principles' for the SEC to focus on investor protection and market integrity, and to 'streamline' self-regulation organisational rule-making process.[39] This approach will let the stock exchanges fill in the details through their self-regulation, and it has the potential to facilitate principles-based regulation to ensure disclosure in the financial system. This could avoid the technicalities of

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[38] Financial Services Authority (UK), *The Turner Review: A Regulatory Response to the Global Banking Crisis* (2009). http://www.fsa.gov.uk/pubs/other/turner_review.pdf. Accessed 25 August 2014.

[39] The Department of the Treasury (US), *Blueprint for a Modernized Financial Regulatory Structure* (2008). http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf. Accessed 25 August 2014.

endlessly overlapping laws in favour of clear and straightforward principles with the advantage of ease of interpretation and enforcement.[40]

We recommend the introduction of a general principles-based standard of disclosure in corporate law with an ethical tone and in the stock exchange operating rules in a plain statement setting out the standard of conduct expected of all those in the financial services industry such as:

> You must keep the financial market fully informed.[41]

This simple statement builds on the experience of principles-based concepts. It builds on the outstanding record of the US rule 10b-5.[42] It is purposely designed to be aspirational, bland, uncontroversial and universal. It does not have 'carve-outs' and exceptions for industry, special considerations and commercial-in-confidence. It builds on the record of short statements of principle in plain English such as the way Australia's Australian Consumer Law (ACL) s 18 has set the standard of conduct in its prohibition of misleading or deceptive conduct:

> [Misleading or deceptive conduct] Section 18(1) A person must not, in trade or commerce, engage in conduct that is misleading or deceptive or is likely to mislead or deceive.

Like the evolution of rule 10b-5 of the *Securities Exchange Act 1934* (US), the expected standard of the financial services licensee will continue to evolve to meet new situations in the marketplace for financial services. The predecessor of the comparable ACL s 18(1) has been described as an 'exocet'[43] because of its ambit and its flexibility. For example, in contrast to negligence at common law, the section is not limited by the requirement for a duty of care based on a relationship of reasonable reliance. The section is potentially wider, and can be used in cases where a duty of care would not exist for the purpose of establishing the common law liability.

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[40] See, eg, John Coffee and Hillary Sale, Redesigning the SEC: Does the Treasury Have A Better Idea? (2009) 95 *Virginia Law Review* 707, 757 (recommending not less power for the SEC but more power).

[41] This compares with British Columbia's proposed Bill 38:

> *A person must not engage in or participate in conduct relating to securities if the person knows, or reasonably should know, that the conduct*
>
> *(a) results in or contributes to a misleading appearance of trading activity in, or an artificial price for, a security, or*
>
> *(b) perpetuates a fraud on any person.*

[42] [Employment of Manipulative and Deceptive Practices] Rule 10b-5: *It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,*

a. *To employ any device, scheme, or artifice to defraud,*
b. *To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or*
c. *To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,*

in connection with the purchase or sale of any security.

[43] A ship launched missile: Warren Pengilley, Section 52 of the Trade Practices Act: a Plaintiff's New Exocet? (1987) 15 *Australian Business Law Review* 247. Section 18 was originally passed as *Trade Practices Act 1974* (Cth) s 52, and was later reenacted as s 18. See eg Paul Latimer, *Australian Business Law*, CCH Australia Ltd, 33rd ed, 2014, para 7-250 et seq.

The section would not have 'carve-outs' and exceptions for industry special considerations etc. We suggest drawing on the successful record of comparable generalist sections mentioned above:

- The standard is objective.
- There can be a breach without knowledge or intention as the statement sets a standard of conduct expected in the financial system.
- Silence - and concealment of a fact - can be in breach. Conduct can be in breach if facts which give rise to reasonable expectations of disclosure are not disclosed.
- If a person is entitled to believe that a relevant (material) fact will be disclosed, failure to communicate the fact may be in breach.
- Those who can take action under the statement are more than those who have relied on the non-disclosure. Action is open to any person who may be concerned about non-disclosure in the financial system - like a shareholder, shareholder action group, the media.
- There is no need for and therefore there are no due diligence defences.

As demonstrated in our submission, as there is a risk of failure to ensure information if regulation is by the regulator alone, it is necessary to return to commission/stock exchange coregulation of the financial system. It is therefore suggested that the best way to overcome the information gap in the current format of disclosure law to ensure and to promote information in the financial system is to enhance coregulation. Coregulation should be enhanced with 'Better Regulation',[44] with more consideration of the regulatory impacts of new laws, designed with regulation impact statements, consultancy and consultation, transparency processes, mechanisms to remove burden, the removal of red tape and simplification. It should be responsive regulation,[45] which will build on the expertise of the financial services industry (the regulated firms) and the institutional environment.

The preferred solution recommended by our submission is a system of effective consolidated coregulation to build on the expertise of both ASIC (government) and a stock exchange (SRO). This would acknowledge the strengths and benefits of each to contribute to an informed financial system.

We cannot say it more strongly when we argue for a principles-based simple, plain English standard for the financial system, with no carve-outs, with an ethical tone that 'You must keep the financial market fully informed'.

[44] See, eg, Robert Baldwin, *Better Regulation ... Is it Better for Business* (Federation of Small Business, 2004). http://www.fsb.org.uk/policy/assets/0952BetterRegulation.pdf; Robert Baldwin, Martin Cave and Martin Lodge, *Understanding Regulation – Theory, Strategy, and Practice* (Oxford University Press, 2nd ed, 2012), especially chapter 3 (Explaining regulation).

[45] Robert Baldwin and Julia Black, Really Responsive Regulation (2008) 71 *Modern Law Review* 59.

APPENDIX

Paul Latimer and Philipp Maume, *Promoting Information in the Marketplace for Financial Services – Financial Market Regulation and International Standards* (ISBN 978-3-319-09458-9, Springer, Berlin, Germany, forthcoming 2014).

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 piecemeal 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 the first chapter, we analyse the role of financial markets and explain the importance of promoting and ensuring information in the marketplace. We follow this in the second chapter 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 chapter 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 chapter 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 chapter 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.

Paul Latimer Philipp Maume
1 May 2014

Latimer and Maume, *Promoting Information in the Marketplace for Financial Services* (ISBN 978-3-319-09458-9, Springer, Berlin, Germany, forthcoming 2014)

ABSTRACT

This book provides a unique comparative and global analysis of the regulation of disclosure in financial (securities) markets. It is written by two authors who represent both the new world (Australia) and the old world (Germany). The authors present their financial markets (securities regulation) research in the global business context, with legal and regulatory perspectives including some references from Africa, Asia, the Middle East and South America.

After every 'boom' and bust', legislators pass new disclosure legislation, often in a heated environment fuelled by politics and the media. Little regard is paid to existing regulation and the experience and outcomes of earlier regulation. The result is the continuing enactment of duplicating and overlapping disclosure laws.

Financial markets are often described as markets for information, so the failure to ensure disclosure is at the heart of financial services regulation. This book argues that the solution for the failure of disclosure 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.

This book examines the reasons for disclosure regulation, and how the efficient operation of financial markets is dependent on disclosure. It examines the adequacy of the common law and the civil law on broker/client disclosure, and concludes that industry licensing in itself fails to keep the market informed. It laments the failures of securities commissions to achieve good disclosure in financial markets, but confirms the effectiveness of coregulation of disclosure by a commission with financial markets (such as the stock exchange). Coregulation builds on financial market self-regulation, and is best described in the words of one-time SEC Chairman William O Douglas in the 1930s as a shotgun behind the door.

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