Fundraising

Capital raising initiatives to build enterprise and employment

Corporate Law Economic Reform Program
Proposals for Reform: Paper No. 2

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ABBREVIATIONS

ACCC	Australian Competition and Consumer Commission
ASC	Australian Securities Commission
ASX	Australian Stock Exchange
CLERP	Corporate Law Economic Reform Program
FSI	Financial System Inquiry
IFA	Investment Funds Association
OIS	Offer Information Statement
SEC	Securities and Exchange Commission (US)
SMEs	Small and medium sized enterprises

Part 1: Reform Proposals

Proposal No. 1 — General Disclosure Test

Prospectuses should disclose what investors and their professional advisers would reasonably require and expect to find in order to make an informed investment decision.

Proposal No. 2 — Shorter Prospectuses

Prospectuses should be shorter and more useful to retail investors. This can be achieved by allowing issuers to provide retail investors with the information which will assist them, without unnecessary details. Additional information, which may primarily be of interest to professional analysts and advisers, can be mentioned in the prospectus and made available free of charge to those who request it.

Proposal No. 3 — Profile Statements

Capital raising using documents other than prospectuses should be facilitated where appropriate. The Australian Securities Commission (ASC) should be empowered to authorise the use in suitable industries of profile statements containing key information determined by the ASC. The prospectus should be available on request for investors requiring more information.

Proposal No. 4 — Comprehensibility

The use of plain English should be encouraged but should not be mandatory; issuers should be free to determine the optimal means of communicating their offers.

PROPOSAL NO. 5 — FORWARD-LOOKING STATEMENTS

Profit forecasts and other forward-looking statements should be based on reasonable grounds but the maker of the statement should not bear the onus of proof.

PROPOSAL NO. 6 — RIGHTS ISSUES

Prospectuses should be required for rights issues but should be limited to information about the transaction and other information not already disclosed to the market.

PROPOSAL NO. 7 — ADVERTISING OF SECURITIES WHICH ARE NOT TRADED ON THE AUSTRALIAN STOCK EXCHANGE

Issuers of securities which are not traded on the Australian Stock Exchange (ASX) should be free to advertise basic information identifying the offer before the prospectus is available. They should not be able to advertise further until the prospectus is available.

PROPOSAL NO. 8 — ADVERTISING OF SECURITIES WHICH ARE TRADED ON THE AUSTRALIAN STOCK EXCHANGE

Issuers of securities which are already traded on the ASX should be able to advertise (without restrictions) before the prospectus is available. The advertisements should include a statement that a prospectus will be made available when the securities are offered and that anyone wanting to acquire the securities will need to complete the application form provided with the prospectus.

PROPOSAL NO. 9 — PATHFINDER PROSPECTUSES

Issuers should be able to distribute pathfinder prospectuses (ie draft prospectuses sent to the non-retail market, normally to assist with pricing).

PROPOSAL NO. 10 — IMAGE ADVERTISING

The advertising restrictions should not inhibit the promotion of a corporation's products or services in the ordinary course of trade. The Law should clearly identify the circumstances in which image advertising will be unlawful as a result of its indirect promotion of an issue of securities.

PROPOSAL NO. 11 — OVERLAP BETWEEN THE TRADE PRACTICES ACT AND THE CORPORATIONS LAW

The liability rules for securities dealings should be contained in the Corporations Law (the Law). Section 52 and the associated consumer protection provisions of the *Trade Practices Act 1974* (and the Fair Trading legislation of the States and Territories) should not apply to dealings in securities.

PROPOSAL NO. 12 — PERSONS LIABLE FOR ALL STATEMENTS IN A PROSPECTUS

The corporation, its directors and the underwriters of an issue should be liable to investors for misleading statements in a prospectus (subject to the uniform defence described below).

PROPOSAL NO. 13 — PROMOTERS

The persons liable under the Corporations Law for a misleading prospectus should not include promoters or persons who 'authorise or cause the issue of' the prospectus, unless they are liable as directors or in some other capacity.

PROPOSAL NO. 14 — PROFESSIONAL ADVISERS AND EXPERTS

Professional advisers and experts should be liable to investors only for misleading statements attributed to them in the prospectus (subject to the

uniform defence described below). Issuers should be required to obtain the consent of professional advisers and experts before attributing statements to them in the prospectus.

Proposal No. 15 — Uniform Defence

A defence should be available to the corporation, directors, underwriters, experts and advisers where they prove that they made such inquiries (if any) as were reasonable, took reasonable care and it was reasonable for them to have believed that the prospectus was not misleading. They should be entitled to rely upon other persons (such as professional advisers and experts) where that is reasonable.

Proposal No. 16 — Fundraising up to $5 Million under an Offer Information Statement

A corporation should be able to raise up to $5 million based on an *offer information statement* (OIS), without preparing a prospectus. In an OIS, the corporation would state what the funds are required for and disclose material information already known to it, but the corporation would not need to undertake due diligence inquiries or commission experts. The OIS would warn investors of the risks of investing without a prospectus and the desirability of obtaining professional investment advice. The OIS would also include audited accounts. The liability and other rules applicable to prospectuses would apply to an OIS subject to appropriate modifications to account for the reduced disclosure. A corporation or enterprise would only be able to issue one OIS in its life.

Proposal No. 17 — Fundraising by Personal Offers

A corporation should not need to prepare a prospectus or OIS to raise up to $2 million each year from 20 or fewer persons who have indicated their interest in offers of that kind or who are likely to be interested in the offer as a result of previous contact or a professional or other connection with the person making the offer. While the number of subscribers would be limited to 20, they could be drawn from a larger pool of persons to whom offers are made.

PROPOSAL NO. 18 — SOPHISTICATED INVESTORS

Issuers should be free to raise funds from sophisticated investors without preparing a prospectus or OIS. Sophisticated investors are those:

- who are investing at least $500,000 in the issue;
- who have net assets of $2.5 million; or
- whose gross income in the previous two years was at least $250,000 per annum.

PROPOSAL NO. 19 — ELECTRONIC COMMERCE

Issuers should be able to issue prospectuses in electronic form and distribute them through the Internet or other media.

PROPOSAL NO. 20 — REGISTRATION

Prospectuses should no longer need to be registered by the ASC, but subscriptions should not be allowed until 14 days after lodgment with the ASC.

PROPOSAL NO. 21 — GOVERNMENTAL IMMUNITY

The Federal, State and Territory Governments and their business enterprises should be subject to the fundraising provisions except in relation to offers of government guaranteed debt securities.

PART 2: INTRODUCTION

This paper has been prepared as part of the Government's Corporate Law Economic Reform Program (CLERP) which is reviewing regulatory requirements with a view to facilitating investment, employment and wealth creation while protecting investors and maintaining confidence in the business environment.

This paper sets out proposals for reforms designed to significantly reduce the cost of fundraising by Australian companies. The proposals have been developed in consultation with the business community, in particular, the Government's Business Regulation Advisory Group, see Appendix A.

Fundraising is one of the key areas identified for review and reform in view of its central importance to business activity. This is especially vital to small and medium sized enterprises (SMEs) which are a source of innovation and will be a major source of future employment. SMEs account for almost half of Australia's private employment and around 40 percent of private sector output.[1] A feature of the proposed reforms is their recognition that special provision should be made for capital raising by smaller enterprises.

An improved environment for raising capital will lower transaction costs and lead to increased levels of investment. To best harness the potential of Australian entrepreneurship, the law must facilitate investment in new and existing enterprises in a way that is cost-effective and underpins confidence in the integrity of our equity markets. The regulatory environment for capital raising has an impact on how quickly new technologies, goods and services can be 'brought to market'. The proposals for reform in this paper aim to facilitate much more efficient and cost-effective access to equity for such enterprises.

The proposed reforms of the fundraising rules are designed to provide:

- a better framework for capital raising by small, medium and large enterprises;

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1 National Investment Council, *Financing Growth: Policy options to improve the flow of capital to Australia's small and medium sized enterprises*, August 1995, p 9. Note also Australian Bureau of Statistics, *Small and Medium Enterprises: Business Growth and Performance Survey*, September 1997, which states that net employment generation in the financial year 1995-96 can be seen to have come primarily from the small business sector.

- investors with relevant, comprehensible and cost-effective information for informed investment decisions; and
- improved opportunities to fund new and growing businesses.

2.1 Scope of this Paper

This paper sets out for public discussion the more significant issues relating to the fundraising rules in Chapter 7 of the Corporations Law. These rules apply generally to offers of securities, including shares, options, debentures and interests in managed investment schemes. On 24 August 1997, the Government announced changes to the Corporations Law concerning managed investment schemes. As part of CLERP, the Government will also be issuing papers on the regulation of futures and securities markets and electronic commerce. Those aspects of electronic commerce which directly relate to fundraising are dealt with in this paper. Legislation implementing the reform proposals of this paper would take account of proposals in other CLERP papers.

This paper also deals with recommendations of the Financial System Inquiry[2] (FSI) which directly affect fundraising. These include recommendations that:

- notwithstanding section 52 of the Trade Practices Act, due diligence defences should operate where a positive duty is imposed to disclose material information (as in prospectuses) (Recommendation 4);
- profile statements should be provided for offers of retail financial products (Recommendation 9); and
- the regulator should promote more effective disclosure and encourage the use of shorter prospectuses, especially for smaller offerings (Recommendation 10).

Action taken in relation to a number of other recommendations of the FSI, which the Government is considering separately, may also affect fundraising. These include recommendations relating to disclosure obligations for retail financial products generally (Recommendation 8), the regulation of financial advisers and dealers (Recommendations 13, 14 and 15), the role and powers of the regulator (Recommendations 27, 28 and 29), the broader regulation of

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2 *Financial System Inquiry Final Report*, March 1997.

financial products (Recommendation 19) and the introduction of a central gateway for dispute resolution (Recommendation 25).[3]

2.2 THE CASE FOR REFORM: CAPITAL MARKET EFFICIENCY AND CONFIDENCE

Corporate fundraising through the issue of equity securities makes a major contribution to the level of investment and therefore economic activity in Australia. For listed corporations alone, the amount of new capital raised in 1996-97 was over $16.4 billion, representing over 4 per cent of the total domestic market capitalisation. Overall, Australia's capital market represents a significant and increasing proportion of the country's wealth. In 1991-92 the market capitalisation of domestic equities listed on the ASX was $186 billion, while by 1996-97, this figure had risen to $387.1 billion.[4]

It is therefore critical that the regulation of fundraising be in accord with a sound economic framework which is pro-business and underpins investor confidence in market integrity.

Under the capital raising system in Australia and major overseas markets, fundraisers must, in general, disclose to prospective investors all material information about the product on offer. For this purpose, they usually undertake due diligence investigations. This regulation is appropriate provided it serves the needs of investors and enhances market confidence.

Disclosure of material information in an effective way places investors in a position to make more confident assessments about securities without undertaking their own costly inquiries. It is generally more practicable and cost-effective for the fundraiser, rather than numerous investors, to undertake inquiries and disclose details about its own business.

Unless disclosure is mandatory, investors will be unable to distinguish poor investments from promising investments in a cost-effective way. Promoters of bad products are unlikely to voluntarily disclose their flaws. Non-disclosure will result in sub-optimal investment and an increase in overall search costs for those investors who are prepared to remain in the market. It will dampen investment confidence and economic activity.

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3 A number of these recommendations are expected to be addressed in other CLERP papers.
4 Figures supplied by the ASX.

In cases where disclosure is appropriate, effective sanctions should be imposed to ensure that the disclosure rules are followed. The sanctions should be directed at ensuring that due diligence inquiries occur where appropriate and that material information is disclosed. They should not serve to increase due diligence and disclosure costs beyond affordable levels (and thereby deter fundraising) nor should they shift to fundraisers the investment risk properly accepted by investors in efficient securities markets. Investments in securities carry an inherent risk accepted by investors in order to receive the higher returns that such investments can bring. If liability for failed investments was imposed on fundraisers regardless of fault, that would discourage capital raising or result in disproportionate due diligence and disclosure costs ultimately borne by investors in the form of increased prices for securities and lower returns. Reducing the return to investors would in turn dampen investment.

Small to medium sized fundraisers are less able to fund full due diligence investigations, particularly in their start-up phase. Further, the disproportionate cost of such investigations for small fundraisers must be recouped in the offer price and may raise it beyond attractive levels. The value of small business to the economy warrants a reduction in current disclosure requirements to a level within the means of the fundraiser, subject to appropriate safeguards on investor protection. Sensible and practical investor protection measures should underpin market confidence.

Sophisticated high-worth investors do not have the same need as others for regulatory protection. Capital raising from such persons should not be inhibited by disclosure rules designed to protect typical retail investors. Hence mandatory rules for disclosure should not extend to such persons, who can safeguard their own interests in a cost-effective manner (which may or may not involve requiring full disclosure by the fundraiser).

The reforms addressed in this paper are designed to:

- maximise market confidence, stability and liquidity;
- promote Australia's international reputation for investment and therefore assist the expansion of the economy, particularly growth in the small business sector;
- create new employment opportunities; and
- facilitate bringing innovative products and services to market quicker.

For a more detailed economic analysis of fundraising, refer to Appendix B.

PART 3: IMPROVING DISCLOSURE: WHAT COMPANIES NEED TO TELL INVESTORS AND WHAT INVESTORS NEED TO KNOW

The primary function of prospectus disclosure is to address the imbalance of information between issuers of securities and potential investors. Prospectuses play an essential role in establishing and maintaining confidence in the capital market because they ensure that the market as a whole and individual investors are appropriately informed and are therefore able to assess the risks inherent in offers of securities. While investors will rely on a range of factors in determining whether to invest, such as the reputation of the fundraiser, prospectuses provide up-to-date information material to the investment decision.

Given the important role of disclosure in the market, prospectus regulation must be efficient. Prospectuses should provide comprehensive, readily understandable information to investors and professional analysts and advisers alike. The cost of undertaking due diligence and preparing a prospectus cannot be justified unless, in practice, it facilitates informed investment decisions. The Law should promote the presentation of reader-friendly information to each of the likely audiences for a prospectus. Retail investors do not generally require the same level of detail as professional analysts and advisers. These investors should not be discouraged from reading prospectuses due to their length and complexity.

Regulatory Framework

The primary prospectus disclosure obligation in the Corporations Law is a general one. A prospectus must contain the information that investors and their professional advisers would reasonably require, and reasonably expect to find in the prospectus, for the purpose of making an informed assessment of the assets and liabilities, financial position, profits and losses, and prospects of the corporation, and the rights attaching to the securities.[5] Under this test,

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5 Corporations Law, subsection 1022(1). For prospectus content requirements for offers of interests in managed investment schemes, see Corporations Regulations, regulation 7.12.12.

information known to persons involved in the preparation of the prospectus and information which it would be reasonable for them to obtain by making inquiries must be included in the prospectus.[6]

In addition to the general rule, the Law also contains minimal requirements dealing with prospectus presentation and content.[7] For example, the prospectus must state the nature and extent of the interests of directors, proposed directors and experts in the promotion of the corporation.[8]

Prospectus Criticisms

Prospectuses are often criticised for being too long and complicated and obscuring information of interest to investors. It is claimed that '[s]ome prospectuses do not inform investors adequately about the nature of the product on offer'.[9] Prospectuses for initial public offerings of shares in large companies are often approximately 100 pages long, and some are considerably longer. A recent study by the Communication Research Institute of Australia on prospectuses for managed investments identified the following difficulties:

- information was difficult to find;
- the language used in the prospectus was too technical;
- the presentation of data was unhelpful; and
- information was absent from the prospectus or was inadequate for making a judgment.[10]

Research commissioned by the ASC indicates that most investors read prospectuses in some detail but have difficulty fully understanding them as a result of their length and complexity.[11]

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6 Corporations Law, subsection 1022(2). The persons involved in the prospectus preparation process for the purposes of this requirement include directors, experts, stockbrokers, underwriters, auditors, bankers and solicitors.

7 Corporations Law, section 1021.

8 Corporations Law, subsection 1021(6).

9 *Financial System Inquiry Final Report*, March 1997, p 265.

10 Communication Research Institute of Australia, *Report to Investment Funds Association and Australian Securities Commission: Developing a performance-based approach to prospectuses*, March 1997, pp 13-14.

11 ASC, *Prospectus Investor Survey Report*, commissioned from Chant Link, 1994, pp 45-46.

For their part, issuers frequently complain that they are forced to burden prospectuses with unnecessary information and that prospectus costs are too high. In 1996, fundraising costs equalled an average of 8.3 per cent of the funds raised in a new listing on the ASX. In 1995, the figure was 11.2 per cent and in 1994 it was 7.5 per cent.[12] These figures are generally higher than costs incurred in, for example, the United States where research into equity capital raisings by corporations in the United States from 1990 to 1994 indicates that the direct costs of an initial public offering in that country average 7.1 per cent.[13]

3.1 The Disclosure Test: General or Checklist

The general disclosure obligation is designed to place the onus on the preparers of a prospectus to provide the information reasonably required by investors and their advisers in deciding whether to subscribe for securities.

Before 1991, the prospectus disclosure test was based on a checklist which required detailed disclosure about a number of specified items.

The current general disclosure test has been criticised on the basis that it has increased the cost of preparing prospectuses compared with the checklist test. However, the checklist test was abandoned because it failed to ensure that investors received comprehensive information. The general test rectifies this problem by focusing directly on the reasonable requirements of investors and their advisers. Market participants generally acknowledge that the current test has improved the quality of disclosure.

The general disclosure test is a proportionate response to the problem of inadequate information under the checklist test. The test is directly linked to reasonable investor requirements and is therefore responsive to changes in market expectations, practices and products over time. A checklist test might fail to cover investor needs in a rapidly developing market.

Some overseas jurisdictions (see below) impose a checklist test supplemented by a general test requiring disclosure of all material information not addressed in the list. This ostensibly has the advantage of setting a standard form to

12 Price Waterhouse, *Annual Survey of Sharemarket Floats January-December 1996*, February 1997, p 2.

13 I Lee and S Lochhead, 'The Costs of Raising Capital', *Journal of Financial Research*, Spring 1996, p 59. Printing and distribution costs will also be high when issuers print a large number of prospectuses for broad distribution.

facilitate comparison between prospectuses. However, key items in prescribed checklists are necessarily described widely (for example, disclosure of 'the risks') which limits the ability to make comparisons. Further, the checklist test overrides legitimate market choice in presentation and may be unhelpful for some audiences and some products.

The general disclosure test should be retained because of its flexibility and effectiveness in ensuring issuers take responsibility for prospectus content.[14]

Overseas Experience

Overseas practice varies on whether general or checklist based disclosure, or a combination of both, is required.

The United States adopts detailed checklist disclosure.[15] The United Kingdom,[16] Ontario[17] and New Zealand,[18] in various ways impose a checklist supplemented by a general requirement to disclose all material matters not disclosed in the checklist.

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14 This was also recommended in the *Financial System Inquiry Final Report*, p 265.

15 The information to be included in a prospectus lodged with the United States Securities and Exchange Commission is set out in section 10 and Schedule A of the *Securities Act 1933*. It includes a description of the company, a description of the securities, terms of the offering, the capitalisation of the company, market and dividend information, risk factors associated with the offering, and a detailed description of the business.

16 In the United Kingdom a general test (upon which ours is based) operates as a 'catch-all' requirement supplementing a detailed list. Different disclosure obligations apply, depending on whether the securities are proposed to be traded on a stock market: *Financial Services Act 1986*, section 146 and *Public Offers of Securities Regulations 1995*, subregulation 8(3).

17 The disclosure test in Ontario requires that a prospectus provide full, true and plain disclosure of all material facts relating to the securities and comply with the requirements of Ontario securities law: *Ontario Securities Act 1990*, section 56. Detailed guidance is given to preparers of prospectuses by extensive specific disclosure obligations in the prospectus 'forms' issued by the Ontario Securities Commission.

18 The New Zealand *Securities Act 1978* relies primarily on checklist based disclosure, with a general requirement that any material matter relating to the offer of securities must be disclosed: Securities Act, section 39 and *Securities Regulations 1983*, regulation 3 and Schedule 1.

Proposal No. 1 — General Disclosure Test

Prospectuses should disclose what investors and their professional advisers would reasonably require and expect to find in order to make an informed investment decision.

3.2 Shorter Prospectuses and Profile Statements

The need to include disclosures which will meet the requirements of a broad range of investors and their advisers contributes to the level of prospectus detail. Prospectus length and complexity is a particular concern for retail investors, who may not be experienced in reading and comprehending technical information. The Law should facilitate the presentation of prospectuses to retail investors in a manner best suited to their needs, while more technical analysis should still be available to investors, professional analysts and advisers who wish to avail themselves of this information.

Regulatory Framework

Documents (or parts of documents) lodged with the ASC under the Corporations Law can be incorporated into a prospectus by reference if:

- the prospectus includes a summary of the document; and
- the prospectus includes a statement that the issuer will provide a copy of the document free on request. [19]

The incorporation-by-reference rule enables issuers to include in a prospectus information contained in other documents lodged with the ASC, without requiring them to repeat all of that information. For example, the rule enables an issuer to incorporate by reference the previous annual report to members.

19 Corporations Law, section 1024F.

Overseas Experience

In the United States, information can be incorporated by reference but only by issuers with whom the market is already familiar because of previous trading in their securities.[20]

Furthermore, in the United States, depending on the type of prospectus registration form used, a summary prospectus may be distributed separately from the full prospectus and offers to subscribe may be based on the summary alone. A full prospectus must, however, be provided before or with the delivery of the securities.

In Ontario, mutual funds can incorporate financial information by reference.[21]

Shorter Prospectuses

There is necessarily a tension between eliciting the comprehensive disclosure of all relevant information and encouraging the issue of short, comprehensible documents to retail investors. As proposed above, the existing general disclosure requirement should be retained. Depending on the complexity of the enterprise in question, the information needed to satisfy this test may be extensive. However, this need not be an insurmountable barrier to shorter prospectuses for retail investors.

Without derogating from the general disclosure test, fundraisers should be able to issue substantially shorter prospectuses for retail investors. Issuers should have the flexibility to omit information provided that it is made available on request and investors are provided with a fair indication of the character of the information.

To facilitate shorter prospectuses while preserving the operation of the general disclosure test, the Law should be amended to enable the ready incorporation by reference of all types of material. The Law currently provides only for the incorporation of documents which are required or permitted to be lodged with the ASC. This limitation is not required for investor protection. Accordingly, the Law should be amended to expressly permit the lodgment of any document with the ASC for the purpose of its incorporation by reference into a prospectus.

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20 SEC Forms S2 and S3.

21 See Ontario Securities Act, sections 53, 54 and 63 and National Policy Statement/CSA Notices, number 36, *Mutual Funds — Simplified Prospectus Disclosure System.*

The current law requires a summary of the omitted material[22], which is intended to ensure that investors are provided with fair notice of the content of the incorporated document. Investor protection does not require a summary of all information incorporated by reference in a prospectus. This is particularly the case in relation to the information which is primarily of interest to professional analysts and advisers rather than retail investors. For information of this kind, incorporation by reference on the basis of a description of the contents of the document should be permitted. There should not be a requirement to summarise the information, provided it is sufficiently identified in the prospectus and it is made clear that it is of a type primarily of interest to professional advisers and analysts. The Law should also require the issuer of the document to provide it free of charge to any person who asks for it.

In regard to information incorporated by reference which may not be primarily for professional analysts and advisers, the prospectus should contain sufficient information to indicate to a potential investor whether they need to obtain a copy of the document. This test is preferable to the current test requiring a summary of the incorporated document. The current test can be difficult to apply in practice.[23] The proposed new test would reflect the ASC's current guidelines for summaries, but would have the advantage of being a clear statement in the Law itself. Again, information dealt with in the above manner should be provided free of charge to any person who requires it.

Taken together, the changes proposed to the incorporation-by-reference facility in the Law should enable issuers to substantially shorten prospectuses while ensuring that retail investors receive fair notice of matters which are important to them.

Issuers are best placed to determine whether a shorter document will assist in the promotion of an offer and investor understanding and to identify the information in which their potential audiences are likely to be most interested. It is not considered practicable or truly responsive to market needs to prescribe the length of prospectuses or mandate the incorporation of documents by reference. The Law should facilitate the shortening of prospectuses in the

22 Corporations Law, section 1024F.

23 The ASC's current guidance on summaries indicates that the summary must be more than a mere reference to the document and should 'provide investors with enough information about that part of the document which is needed . . . for them to make an informed decision as to whether to obtain a copy. This would include disclosing the substance of those matters which would, had they not been mentioned in the summary, take the investor by surprise on a subsequent reading of the document.' ASC Practice Note 63, *Incorporation by Reference — s1024F*, 15 July 1996, paragraph 63.13.

manner outlined above, but the optimal use of the mechanism provided by the Law should be determined by market forces.

Proposal No. 2 — Shorter Prospectuses

Prospectuses should be shorter and more useful to retail investors. This can be achieved by allowing issuers to provide retail investors with the information which will assist them, without unnecessary details. Additional information, which may primarily be of interest to professional analysts and advisers, can be mentioned in the prospectus and made available free of charge to those who request it.

Mandatory Profile Statements

The FSI recommended that a profile statement be required for all prospectuses and that investors be permitted to invest solely on the basis of this statement.[24] A full prospectus would be required to be lodged with the regulator and available to investors on request.

A mandatory requirement for a profile statement could:

- provide uniform information on key aspects of the investment, including the risks and possible returns, in a manner which facilitates investor comprehension and comparison between products; and
- be used as a stand-alone document sufficient for many investors to assess the investment, thus saving issuers the cost of printing and distributing the full prospectus. The prospectus would still be available on request and without charge from the prospectus issuer for those investors who request it.

Overseas Experience

There are international precedents for profile statements, although some are more limited in scope than those envisaged by the FSI. The United States Securities and Exchange Commission (SEC) has commenced a project for profile statements for certain mutual funds. A full prospectus would need to be delivered to investors no later than on confirmation of any investment

24 *Financial System Inquiry Final Report*, p 267.

made. The SEC is not proposing to extend these arrangements to other forms of securities, essentially because of the numerous potential variations in other investments. Similarly the Ontario Securities Commission has commenced a project to develop profile statements, but again this is confined to mutual funds.

New Zealand, however, is introducing a profile statement regime applying to all securities. An 'investment statement', intended for use by the 'prudent but non-expert'[25] investor, will set out answers to eleven key questions, which are considered important in making an investment decision.[26] Investors will be able to invest on the basis of the investment statement alone. The application form for securities will be part of the statement. A full, registered prospectus will still have to be prepared. However, it will be permissible for the prospectus to form part of an annual report or another document required by legislation. The prospectus will have to be distributed to any person who asks for it.

Are Mandatory Profile Statements Suitable for Australia?

If it is to be useful for investors in comparing different products, a profile statement would have to be provided against specific criteria. The FSI proposed that the criteria to be addressed in a profile statement for primary issues of securities would include:

- an outline of the nature of the investment;
- the standard charges for purchasing and selling the securities;
- the risks involved in the investment; and
- other disclosures for specific products considered appropriate by the regulator.[27]

The ASC and the Investment Funds Association (IFA) have been working jointly on a project to develop a short form disclosure document for use by the managed investments industry. Their work suggests that a more extensive list

25 Securities Act, section 38D.

26 The questions to be addressed are: what sort of investment is this; who is involved in providing it for me; how much do I pay; what are the charges; what returns will I get; what are my risks; can the investment be altered; how do I cash in my investment; who do I contact with enquiries about my investment; is there anyone to whom I can complain if I have problems with the investment; and what other information can I obtain about this investment?

27 *Financial System Inquiry Final Report*, Recommendation 9, pp 266-268.

than that proposed by the FSI would be necessary, at least in the context of managed funds. The list of matters to be addressed in the short form document sanctioned by the ASC was drawn up in light of a detailed empirical study conducted by the Communications Research Institute of Australia. The Institute's study has been instrumental in leading to a limited pilot project from 1 July 1997. The aim is to give fund managers the option of marketing their investments on the basis of a short form document with a full prospectus available on request. The short document will contain information which is material to making an informed assessment of:

- what is being offered;
- the risks of the investment;
- the management company and the trustee;
- accessing and changing the investment; and
- the information that can be obtained from the management company.[28]

The short form document must also contain prominent statements to the effect that:

- other information is contained or referred to in the full prospectus;
- investors will receive a copy of the full prospectus either during the application period or no later than one month after the securities are issued; and
- potential investors should consult an investment adviser and a taxation adviser before making their investment decision.

Selecting criteria for profile statements which reflect current market conditions and products and which can be kept up to date requires on-going monitoring and consultation with industry. The ASC and IFA's work in this area is currently being tested in the market to assess the appropriateness of their proposed checklist. Identifying and specifying criteria which would be suitable across the broad range of fundraising activities undertaken in the capital market would be a complex process and one for which the Corporations Law is not well suited.

While some products may benefit from individually-tailored profile statements sanctioned by the ASC, if the Law were to mandate profile statements it would impose additional costs on issuers. Issuers would need to

28 Joint Media Release of ASC and IFA, ASC 97/109, *Simpler Managed Investment Prospectuses*, 11 May 1997.

ensure that both the profile statement and the prospectus made the correct disclosures for those documents. As the primary source of information for retail investors, the profile statement would need to attract liability for any failure to adequately address the matters required to be disclosed in it.[29] The costs of ensuring that the profile statement did not attract liability would be greater if broad criteria were adopted for the contents of a profile statement, as would be necessary if it were designed to cover all products.

For these reasons, a requirement in the Corporations Law that profile statements must be prepared against legislatively mandated criteria is not recommended.

However, given the possible advantages to investors in receiving short and manageable profile statements, it is proposed to give the ASC a discretion to prescribe specific content requirements for a profile statement, if this is considered desirable for a particular industry in fostering a better investment climate. It is envisaged that this would occur in consultation with relevant industry groups (as is occurring with the ASC/IFA work). Industry-specific profile statements would enable investors to make comparisons between similar products.

In order to facilitate profile statements, the ASC should be given sufficient power to apply the prospectus provisions of the Law to profile statements, subject to appropriate modifications to take account of their different nature.

The FSI also recommended that the regulator should work with industry and professional groups to promote more effective disclosure in prospectuses, including the use of consumer testing to eliminate information overload.[30] Legislative intervention is not required to achieve this outcome. Indeed, it would be difficult, if not impossible, to legislate for a worthwhile change of this kind. The project on managed investments described above illustrates what can be achieved by the regulator and industry.

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29 To allow an issuer to rely on the full prospectus in claiming that full and proper disclosure had been made would result in investors who were misled by a defective profile statement not having an action in damages, even though they were entitled to assume that an investment decision could be made on the basis of the profile alone. This appears to have been proposed in the *Financial System Inquiry Final Report*, pp 266-267.

30 *Financial System Inquiry Final Report*, Recommendation 10, p 269.

Proposal No. 3 — Profile Statements

Capital raising using documents other than prospectuses should be facilitated where appropriate. The ASC should be empowered to authorise the use in suitable industries of profile statements containing key information determined by the ASC. The prospectus should be available on request for investors requiring more information.

3.3 Comprehensibility

Prospectuses are often criticised as being difficult to understand. This could be addressed by requiring that prospectuses must be written in plain English or must be comprehensible to investors.

Regulatory Framework

There is no express requirement regarding comprehensibility of prospectuses. However, there are prohibitions against the inclusion of misleading statements.

Overseas Experience

In the United States, the SEC encourages the clear, concise and understandable presentation of information in prospectuses and mandates the use of descriptive headings and captions and reasonably short paragraphs and sections. [31] The SEC also proposes to introduce a further rule to improve the quality of prospectus disclosures, which would require the mandatory cover page, summary and risk factor sections of a prospectus to be written in plain English.[32] There has not been significant industry support for this proposed rule.

31 SEC Rule 421(b).

32 SEC Release No. 33-7380, *Plain English Disclosure.*

In the United Kingdom, a prospectus must 'be presented in as easily analysable and comprehensible a form as possible'.[33]

The law in Ontario requires a prospectus to be presented in a narrative form and provide full, true and plain disclosure of all material facts relating to the securities issued or proposed to be distributed.[34]

New Zealand law does not contain a specific comprehensibility requirement.

Is a Mandatory Comprehensibility Rule Justified?

Prospectuses which are so poorly presented as to be uninformative or misleading to a prospective investor would breach the current disclosure requirement and the requirement that prospectuses not be misleading. Hence the current law in effect includes a general comprehensibility requirement. To impose an additional requirement relating to the style of the document rather than its substance (such as a plain English requirement) would increase compliance costs (which would be passed on to investors) without necessarily resulting in commensurate gain for investors. Deciding whether a statement has been expressed in plain English is a particularly subjective judgment. Uncertainty about whether statements are plain enough for the purposes of a legislative rule could lead to excessive caution on the part of prospectus issuers and result in longer prospectuses.

Prospectuses are sales documents, as well as serving an information function. They are usually prepared by professionals with a view to marketing the offer. Provided the Law does not impose arbitrary rules for the presentation of material, market forces will tend to generate prospectuses in which the amount spent on presentation (beyond the threshold requirement that the prospectus make disclosure and not be misleading) is optimal having regard to other factors such as the amount sought to be raised and the sophistication of potential investors in the relevant market. The reforms outlined above to facilitate shorter prospectuses will assist issuers in targeting their offers to the retail market.

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33 Public Offers of Securities Regulations, subregulation 8(3).
34 Ontario Securities Act, section 56.

Proposal No. 4 — Comprehensibility

The use of plain English should be encouraged but should not be mandatory; issuers should be free to determine the optimal means of communicating their offers.

3.4 Forecasts

Forecasts in prospectuses, particularly profit forecasts, provide potentially useful information which can be very influential in making an investment decision. However, the current rules on forecasts have been criticised on the grounds that:

- forecasts are inherently unreliable and accordingly should be prohibited; and
- the reverse onus of proof applying to forecasts is unduly onerous on issuers.

Regulatory Framework

A forecast must be included in a prospectus if an investor would reasonably require and reasonably expect to find a forecast in the prospectus for the purpose of making an informed assessment of the prospects of a corporation.[35] Of the prospectuses lodged with the ASC between July and December 1995 offering equity interests in new ventures, 55 per cent contained a financial forecast of some sort.[36]

If a prospectus includes a forward-looking statement, that statement is deemed to be misleading unless the maker of the statement has reasonable grounds for making it.[37] In any litigation concerning a misleading forward-looking statement, the maker of the statement is taken not to have had reasonable grounds for making the statement, unless they can produce

35 See Corporations Law, section 1022.
36 ASC *Issues Paper: Inclusion of Financial Forecasts in Prospectuses*, October 1996, paragraph 6.3.
37 Corporations Law, subsection 765(1).

evidence to the contrary.[38] Generally, in actions for damages under the Corporations Law, the plaintiff (the investor) bears the onus of proving that a statement of the issuer was in fact misleading. The opposite approach is adopted in relation to forecasts, based on the Trade Practices Act.[39]

There is judicial authority for the view that, at least for mining corporations, the practice of including forecasts supports the proposition that these are reasonably required for making an informed investment decision.[40] This view has not been universally accepted.[41]

Overseas Experience

There is no positive obligation to include forecasts in prospectuses in the United States, the United Kingdom[42], Canada or New Zealand. However, each of these jurisdictions has rules about the presentation of forecasts or the liability attached.

In the United States, forecasts are generally not included in prospectuses. In order to encourage the inclusion of forecasts, United States securities law provides protection for forward-looking statements by offering an immunity from civil liability, known as the safe harbour rule. The rule has evolved through case law and SEC rulings and is now embodied primarily in the *Private Securities Litigation Reform Act 1995*. The safe harbour under this Act will be available if a forward-looking statement in a prospectus is identified as such and is accompanied by meaningful cautionary statements of important factors that could cause actual results to differ materially from those projected in the forward-looking statement. The statement must also have a reasonable basis in fact and be made in good faith.[43] However, the Act is of limited application in that it does not protect forward-looking statements made in the context of an initial public offer of securities.

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38 Corporations Law, subsection 765(2).

39 Trade Practices Act, section 51A. Note, however, that subsection 765(2) of the Law arguably creates an evidentiary onus with the ultimate onus resting on the investor plaintiff.

40 See *Pancontinental Mining Ltd v Goldfields Ltd* (1995) 16 ACSR 463 at 469 per Tamberlin J.

41 See *Solomon Pacific Resources NL v Acacia Resources Ltd* (1996) 14 ACLC 505 at 508 per McLelland C J. This was a takeovers case but dealt with a similar issue in that context.

42 Although the United Kingdom legislation contains a ‘catch all’ disclosure provision like section 1022 of the Corporations Law, it is not viewed as generally requiring the inclusion of profit forecasts.

43 See CCH, *Federal Securities Law Reporter*, paragraph 5420.

A recent analysis of the impact of the Private Securities Litigation Reform Act carried out by the SEC suggests that, in its first year of operation, it has had little impact on the extent to which forecasts are included in the prospectuses to which it applies. This could, at least in part, be attributed to potential liability under State legislation, where forward-looking statements may not be protected by Federal law.[44]

In the United Kingdom, the rules of the London Stock Exchange, which apply to both listed and unlisted securities, require that where a profit forecast or estimate is included in a prospectus, the principal assumptions upon which the profit forecast is based must be stated. The reporting accountants or auditors must report on the forecast and their report must be included in the prospectus.[45]

In Ontario, a projection, if it is included, must be based on assumptions that reflect the entity's planned courses of action for the period covered. A forecast or projection in a prospectus must be supported by an accountant's view of the statement, and must be prepared in accordance with accounting standards. These standards include a requirement that significant assumptions underlying forecasts or projections be disclosed.[46]

In New Zealand,[47] if a profit forecast is included in a prospectus, the prospectus must contain a statement of the principal assumptions on which it is based. The auditor's report is also required to include a statement that the forecast has been properly compiled on the footing of the assumptions made or adopted by the issuer.

Regulating Prospectus Forecasts

Forecasts in prospectuses, particularly profit forecasts, are often central to the investment decision because they deal directly with investment returns.

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44 SEC, *Report to the President and Congress on the first year of practice under the Private Securities Litigation Reform Act 1995*, April 1997, p 5. The *Securities Litigation Uniform Standards Bill 1997* will, if enacted, enable defendants in class action securities litigation being pursued in State courts to remove those actions into Federal jurisdiction and thereby avail themselves of the safe harbour which exists under Federal law.

45 *The Listing Rules of the London Stock Exchange*, Rule 6.G.2 and Appendix to *The Unlisted Securities Market Rules*, paragraph 7(b).

46 See Securities Act Regulations, regulation 60 and National Policy Statement/CSA Notices number 48.

47 See Securities Regulations, regulation 5.

However, as stated above, the inclusion of forecasts in prospectuses has been criticised because, it is said, they are inherently unreliable.

Forecasts are potentially liable to mislead because the future performance of a company depends on numerous factors (such as economic conditions) which cannot be predicted with accuracy. Issuers of a prospectus may have an unduly optimistic expectation of the venture in question and will also be concerned to attract investment. These factors may combine to result in an overstatement of matters less susceptible to objective analysis, such as profit forecasts.[48]

However, where it is reasonably practicable to forecast returns, this should be done to enable properly informed investment decisions to be made.

In order to ensure that forecasts are not made on the basis of genuine but unreasonable beliefs of issuers, forecasts should only be made where there is a reasonable basis for them. This outcome is achieved under the current law which deems a forward-looking statement to be misleading unless there are reasonable grounds for it. Arguably this adds little to the operation of the general disclosure test, but the current law should be retained to put the matter beyond doubt.

In some instances, for example highly speculative investments in mineral exploration, meaningful forecasts may not be possible. Whether a forecast is required should be left for determination under the general prospectus content rule, namely by reference to whether the forecast would be reasonably required.

Meaningful forecasts should be encouraged because of their usefulness to potential investors. The reverse onus discourages the inclusion of material of potential use to investors because issuers perceive that its operation exposes

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48 Data in Price Waterhouse, *Annual Survey of Sharemarket Floats January-December 1996*, February 1997, suggests that for January to December 1996, for floats over $100 million, 84 per cent came within 15 per cent of their profit forecast in the first year out, 13 per cent were 15 per cent or more above the profit forecast and only 3 per cent were 15 per cent or more below the profit forecast. In the second year out, 48 per cent came within 15 per cent of the profit forecast, 28 per cent were 15 per cent or more above the profit forecast and 24 per cent were 15 per cent or more below the profit forecast. For floats below $100 million, profit forecasts were more likely to overstate the position than for floats over $100 million: 47 per cent came within 15 per cent of their profit forecast in the first year out, 18 per cent were 15 per cent or more above the profit forecast whilst 35 per cent were 15 per cent or more below the profit forecast. In the second year out, 33 per cent came within 15 per cent of the profit forecast, 15 per cent were 15 per cent or more above the profit forecast and 52 per cent were 15 per cent or more below the profit forecast.

them to liability for legitimate forecasting. Even if, as a matter of law, its operation does not go that far,[49] in practice it deters the inclusion of meaningful forecasts (as confirmed by criticisms from issuers and their professional advisers).[50] Accordingly, the reverse onus should be removed.

As noted above, while comparable overseas jurisdictions do not impose a reverse onus of proof for forecasts, they do require the disclosure of the assumptions behind a forecast. This disclosure is important because it enables potential investors to assess the value of the forecast. Reasonable assumptions make it more likely that a particular forecast will be achieved. It is not proposed that the Corporations Law specifically mandate disclosure of the assumptions behind a forecast. The general disclosure test already requires the information disclosed about prospects to be sufficient to enable potential investors to make an informed assessment. Proper disclosure about prospects and forecasts cannot be made without explaining the considerations behind the projected results.

Proposal No. 5 — Forward-Looking Statements

Profit forecasts and other forward-looking statements should be based on reasonable grounds but the maker of the statement should not bear the onus of proof.

3.5 PROSPECTUSES FOR RIGHTS ISSUES

Rights issues are offers to existing members of a company to subscribe for additional shares, usually at a discount to the market price. As a result of continuous disclosure rules, substantial information is available in relation to securities which are already traded on the ASX. That raises the issue of whether a prospectus should be required as well.

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49 Subsection 765(2) arguably creates an evidentiary onus with the ultimate onus resting on the investor plaintiff. In any event, once a statement is found to be misleading the defendant has the onus of establishing the due diligence defence (see section 4.1 below on liability).

50 The removal of the reverse onus of proof was recommended, with some qualification, by the Prospectus Law Reform Sub-committee of the Companies and Securities Advisory Committee: see *CASAC Prospectus Report*, March 1992, p 34.

Regulatory Framework

Since 1994, reduced disclosure obligations have applied to prospectuses for offers of securities which are already traded on the ASX.[51] The prospectus must disclose information about the effect of the offer on the issuer and the rights attaching to the securities, but it need not address the financial position and prospects of the company. The prospectus is said to be *transaction specific*.

This reduced disclosure is justified because entities with securities traded on the ASX are subject to continuous disclosure obligations. Price-sensitive information about their securities must be continuously disclosed, with the exception of confidential information. Any relevant confidential information which has not previously been disclosed must be included in a transaction specific prospectus.

Overseas Experience

A concessional disclosure regime for offers of securities where the issuer has been keeping the market informed on a continuous basis is consistent with the practice in the United States[52] and in Ontario.[53] A full prospectus is required in the United Kingdom for offers of securities of this kind.[54] New Zealand provides a complete exclusion from the prospectus requirements for rights issues.[55]

Should a Prospectus be Required for Rights Issues?

Despite the reduced level of disclosure, preparing a transaction specific prospectus imposes some costs and time delays on the issuer. This may discourage some issuers from making rights issues, particularly where it is viable to raise funds within existing exceptions to the prospectus requirement (for example, from sophisticated investors).

However, removing the requirement for a transaction specific prospectus could result in material information not being provided to investors, even if

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51 See Corporations Law, section 1022A and ASC Practice Note 66, *Transaction Specific Prospectuses*, 4 September 1997.
52 SEC Form S3.
53 Ontario Securities Act, section 73.
54 Public Offer of Securities Regulations, regulation 5.
55 Securities Act, section 6.

continuous disclosure obligations resulted in this information being limited. In particular, it would be inappropriate for a corporation to be able to make a rights issue without disclosing confidential information which had previously been withheld. This type of information may be critical in making an investment decision.

The narrow scope of the additional disclosure required in a transaction specific prospectus provides a significant benefit for issuers. Preparation costs are reduced because less information is included in the prospectus. Market reaction to date suggests that the current law is working effectively and has resulted in much shorter and easier-to-produce prospectuses. Accordingly, no change is proposed.

Proposal No. 6 — Rights Issues

Prospectuses should be required for rights issues but should be limited to information about the transaction and other information not already disclosed to the market.

3.6 Advertising

The existing rules on advertising are sometimes claimed to be unduly restrictive and at times not fully complied with. It is sometimes suggested that advertising would be adequately regulated by reliance on the prohibition against misleading conduct[56] alone.

Regulatory Framework

Advertising a proposed offer of securities is prohibited until a prospectus has been lodged with and, if necessary, registered by, the ASC. In order to prevent avoidance of this restriction by indirect means, the publication of reports which draw attention to proposed offers is also prohibited. However, there are exceptions for reports generated in the ordinary course of business, such as news reports. The ASC has also modified the Law to permit issuers which are

56 Corporations Law, section 995.

or will be listed on the ASX to publish basic information about the offer before a prospectus is issued.[57]

After a prospectus has been lodged and, if necessary, registered, advertising is permitted, provided it contains specific details drawing attention to the availability of the prospectus.[58] This post-prospectus advertising is regulated by the prohibition on misleading or deceptive conduct.

Market Facilitation through Advertising

Restrictions on advertising of securities exist in Australia and in most overseas jurisdictions to ensure that the prospectus is the primary basis of investment decisions. Pre-prospectus advertising campaigns in particular could cause investment decisions to be made before a prospectus is available to correct misconceptions. Once an investment decision is made, the influence of a subsequent prospectus is diminished.

While the underlying policy rationale for regulating advertising remains sound, there is nonetheless scope to examine the detail of the regulation to ensure that it does not go further than is necessary to meet regulatory objectives. For example, advertising restrictions should not inhibit the free flow of non-promotional information to raise market awareness of a float.

In this regard, the liberal post-prospectus advertising rules appear to be operating satisfactorily. However, problems remain in the pre-prospectus area.

Overseas Experience

There is a wide range of approaches to regulating advertising in other jurisdictions. The United States and Ontario are generally more restrictive than Australia. Both effectively prohibit pre-prospectus advertising. The form and content of advertising after the registration of the prospectus is also restricted, essentially limiting advertisements to basic details.[59]

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57 See ASC Policy Statements 54, *Pre-prospectus Advertising*, 11 May 1993 and 101, *Prospectus Advertising Provisions*, 2 October 1995.

58 Corporations Law, subsection 1025(2).

59 See Ontario Securities Act, sections 50, 65 and 69 and the United States Securities Act, paragraph 2(10)(a) and SEC Rules 134 and 482. Rule 482 relaxes the restriction in relation to investment companies.

A much more liberal approach is taken in the United Kingdom. Advertisements announcing a public offer of securities for which a prospectus is required are permitted provided they are approved by an authorised person, state that a prospectus will be published and give an address in the United Kingdom from which it will be obtainable.[60]

In New Zealand, advertisements are permitted prior to the registration of a prospectus, but must be restricted to statements of intention, reports of general meetings, and reports for stock market compliance. Advertising is permitted after registration of a prospectus provided it refers to the prospectus.

What Advertising Rules Should Apply to Unlisted Securities?

Securities which are not traded on the ASX are more susceptible to market distortion through advertising campaigns.

The publication of basic information should be permitted because that will facilitate better awareness of a float without unduly influencing investment decisions. Apart from that, and ASC relief in exceptional cases, unquoted securities should not be able to be advertised before a prospectus is available to the market. This is because there will generally not be an informed market for the securities. The only information which will be available is that which the issuer has elected to provide.

The information allowed in prospectus advertising of offers of securities not traded on the ASX should be limited to:

- a statement identifying the offeror and the securities;
- a statement that a prospectus for the offer will be made available when the securities are offered;
- a statement that anyone who wants to acquire the securities will need to complete the application form in or with the prospectus; and
- an invitation to register to receive the prospectus.

60 Financial Services Act, section 154 and Public Offer of Securities Regulations, regulation 12. The nearest Australian equivalent to an authorised person is a licensed securities dealer but it should be noted that securities dealers are generally subject to more supervision in the United Kingdom.

Proposal No. 7 — Advertising of Securities which are not Traded on the Australian Stock Exchange

Issuers of securities which are not traded on the ASX should be free to advertise basic information identifying the offer before the prospectus is available. They should not be able to advertise further until the prospectus is available.

The proposed rule for non-exchange traded securities reflects existing ASC class order relief, although the availability of the new exception would not be restricted (as it is under the class order) to securities which are proposed to be traded on the ASX.

What Advertising Restrictions Should Apply to Securities which are already Exchange Traded?

Corporations should have greater freedom to engage in pre-prospectus advertising of offers of securities that are already traded on the ASX. This is because information about the corporation and its securities will already be available to the market and investors through continuous disclosure rules. Moreover, there will be an externally-determined price for the securities reflecting the market's assessment. Therefore, there is significantly less danger of investment decisions being distorted by an advertising campaign that, for example, involves the selective release of information. Accordingly, the ASC's exception relating to offers of already-quoted securities should be expanded and set out in the Corporations Law.

Proposal No. 8 — Advertising of Securities which are Traded on the Australian Stock Exchange

Issuers of securities which are already traded on the ASX should be able to advertise (without restrictions) before the prospectus is available. The advertisements should include a statement that a prospectus will be made available when the securities are offered and that anyone wanting to acquire the securities will need to complete the application form provided with the prospectus.

Pathfinder Prospectuses

Pathfinder prospectuses are draft prospectuses circulated to the non-retail market for comment in order to assist the issuer to set a realistic price and finalise the contents of the prospectus. In practice the distribution of pathfinders is often treated as exempt from advertising restrictions.[61] The ASC has a policy of providing relief where the securities will be traded on the ASX, but in practice this is not relied on.[62]

Pathfinder prospectuses serve a useful purpose without causing any detriment to investors.

Proposal No. 9 — Pathfinder Prospectuses

Issuers should be able to distribute pathfinder prospectuses (ie draft prospectuses sent to the non-retail market, normally to assist with pricing).

Image Advertising

Image advertising extols the virtues of a corporation without expressly referring to its pending public offer. In practice, image advertising can be very influential on investors. However, there is often uncertainty as to whether a particular image advertising campaign breaches the restrictions on pre-prospectus advertising or is permissible advertising of the company's general business in the ordinary course of trade.[63]

In order to provide certainty to the market and the ASC in relation to image advertising, it is desirable to clarify the Law. The Law should set out criteria to assist the ASC to determine whether a breach of the advertising rules has occurred or whether to grant an exemption from the advertising rules. Corporations planning to undertake image advertising that could potentially breach the advertising rules should be able to apply to the ASC for an exemption, based on the criteria.

The criteria should include whether the advertising:

61 See Corporations Regulations, paragraph 7.12.06(a).
62 ASC Policy Statement 8, *Pathfinders,* 20 August 1991.
63 Corporations Law, paragraph 1026(2)(c).

- forms part of the normal advertising of a corporation's products or services directed to its customers;
- communicates information that materially deals with the affairs of the corporation; and
- is likely to encourage investment decisions being made on the basis of the advertisement rather than information contained in the prospectus.

Proposal No. 10 — Image Advertising

The advertising restrictions should not inhibit the promotion of a corporation's products or services in the ordinary course of trade. The Law should clearly identify the circumstances in which image advertising will be unlawful as a result of its indirect promotion of an issue of securities.

PART 4: REDUCING TRANSACTION COSTS

4.1 LIABILITY

Liability for prospectuses is often said to be:

- excessive; and
- administered under an unduly complex regime.

Concerns about personal liability are said to increase the cost of due diligence investigations and the amount of detail in prospectuses as directors and professionals seek to avoid all prospect of damages claims should the company's performance not match expectations. Concerns are greatest in relation to the Trade Practices Act which imposes liability whether or not there was fault.

Regulatory Framework

The liability rules for defective prospectuses and issues of securities not requiring a prospectus are contained primarily in the Corporations Law. In addition, remedies may be available under the Trade Practices Act and the equivalent provisions in the State and Territory Fair Trading Acts, as well as under the common law.

Under the Trade Practices and Fair Trading Acts, the corporation and other persons who, in trade or commerce, *engage in* conduct which is misleading or deceptive or likely to mislead or deceive will be liable to persons suffering loss as a result, irrespective of the amount of care taken. The remedies available to such persons include damages.[64] In the case of a prospectus, not just the corporation but also directors and others who sign or put their name to the prospectus or the particular misleading statement may be liable as having *engaged in* misleading conduct. If they have not *engaged in* the corporation's

64 Trade Practices Act, sections 52, 82 and 87.

misleading conduct then in essence they will only be liable under the Acts if they acted with a guilty mind.[65]

The Corporations Law contains a regime of liability specifically tailored to prospectuses.[66] Under this regime, liability in damages for a misleading prospectus extends to the corporation, directors (including persons named as directors or prospective directors), promoters, persons who authorised or caused the issue of the prospectus and, if they have consented to be named, stockbrokers and underwriters. Another group — primarily experts, auditors, bankers, solicitors and other persons assisting the corporation in relation to the issue — are liable for their own misleading statements or omissions, if named with their consent.

Defences, known as due *diligence defences*, are available to each of the above persons with liability under the Corporations Law. These defences are formulated in different terms for different people but generally require them to have made reasonable inquiries and reasonably believed that the statement in question was not misleading.[67]

Persons not falling within the above categories will be equally liable under the Corporations Law if they participated in a contravention of that Law with a guilty mind.[68]

In addition to the specific prospectus liability provisions, the Corporations Law also includes more general market conduct provisions which impose liability in relation to misleading conduct in securities dealings, false or misleading statements in relation to securities and fraudulently inducing persons to deal in securities.[69] These apply to prospectuses as well as in other contexts. Most importantly, section 995 of the Corporations Law provides that a person shall not engage in misleading conduct in connection with a securities dealing. This generally imposes strict liability, though the due diligence defences are arguably available in relation to statements made in prospectuses.

A court may relieve an officer or expert of liability for default or breach of duty if 'the person has acted honestly and . . . having regard to all the

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65 Trade Practices Act, section 75B and *Yorke v Lucas* (1985) 158 CLR 661.

66 Corporations Law, sections 996 and 1005-1012.

67 Corporations Law, sections 1008A, 1009 and 1011. Other defences of less significance are also available such as having withdrawn consent for the issue of the prospectus.

68 Corporations Law, sections 79 and 1005. The test is the same as under section 75B of the Trade Practices Act, addressed in *Yorke v Lucas* (1985) 158 CLR 661.

69 Corporations Law, sections 995 and 999-1000.

circumstances of the case . . . [they] ought fairly to be excused'.[70] This apparently enables the court to relieve officers or experts of any liability other than liability under the Trade Practices Act.

Interested parties may also apply to the courts for injunctions to prevent fundraising based upon a misleading prospectus, and the ASC has the power to issue *stop orders* having the same effect.[71] The Corporations Law also imposes criminal liability in respect of certain breaches of the Law relating to securities.

Finally, the common law provides various rights to a plaintiff who has been misled by a prospectus. The common law is primarily fault-based, allowing damages for deceit or negligent misstatement.[72] However, any misrepresentation which becomes a term of a contract gives rise to strict liability. Furthermore, the remedy of rescission is generally available against a corporation which, even without fault of its own, issues a misleading prospectus.[73]

Transaction Costs of the Liability Regime

The existing disclosure and liability regime for prospectuses is commonly regarded as resulting in high transaction costs. Unlike other commercial transactions entered into by the corporation, in the case of a prospectus the directors, professional advisers and others are made liable to investors for misleading statements whether or not they have acted fraudulently. This results in costly due diligence as those persons seek to avoid any mistakes. It may also encourage those persons to include unnecessary details in a

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70 Corporations Law, section 1318.

71 Corporations Law, sections 1033, 1323 and 1324.

72 Note also *Misrepresentation Act* 1971 (SA), *Law Reform (Misrepresentation Ordinance)* 1977 (ACT) and *Esanda v Peat Marwick Hungerford* (1997) 23 ACSR 71.

73 Rescission (which is a discretionary remedy) has traditionally not been available where:

- the plaintiff has affirmed the contract after discovering the misrepresentation: *Elders Trustee and Executor Co Ltd v Commonwealth Homes and Investment Co Ltd* (1941) 65 CLR 603;
- the parties cannot (by the use of appropriate equitable remedies) be restored substantially to the position they had before the contract was entered into: *Palmer's Company Law,* vol 1, paragraph 5.611; *Alati v Kruger* (1955) 94 CLR 216, *Krakowski v Eurolynx Properties Ltd* (1995) 183 CLR 563 at 586; *Vadasz v Pioneer Concrete (SA) Pty Ltd* (1995) 184 CLR 102 at 110ff; and
- the interests of creditors would be jeopardised by rescission (at least in some circumstances): Butterworths *Australian Corporations Law, Principles and Practice*, paragraph 7.4.180. Note also *Elders Trustee and Executor Co Ltd v Commonwealth Homes and Investment Co Ltd* (1941) 65 CLR 603 at 618-619.

prospectus out of an abundance of caution to ensure that all disclosures are made and all potential liability avoided.

In general, imposing personal liability on those directly involved in the making of misleading statements in a prospectus encourages compliance with disclosure requirements thereby maintaining market integrity at high standards. However, within these parameters, the liability of each category of person should be commensurate to their proper role in preparing the prospectus.

Currently, the Law imposes wide responsibilities on a large number of people going beyond what is appropriate to ensure market integrity. In some cases, liability is imposed on people for conduct outside their proper responsibilities. In other cases, liability is strict when it should be based on fault. These matters result in higher compliance costs without commensurate benefits to investors. In fact, the current system operates to the ultimate detriment of investors who indirectly pay all expenses associated with inefficiencies of the system.

Overlap between the Trade Practices Act and the Corporations Law

There has been considerable public debate about the overlap between the Corporations Law and the Trade Practices Act in relation to dealings in securities. Apart from substantive differences, an issue also arises about overlapping jurisdiction of the ASC and the Australian Competition and Consumer Commission (ACCC).

In September 1996, the Corporations Law Simplification Task Force recommended that section 52 of the Trade Practices Act (and the State and Territory Fair Trading Acts) should no longer apply to conduct in relation to fundraising and other dealings in securities to which the Corporations Law applies.[74] The FSI also examined this issue and concluded that the due diligence defences associated with a positive duty to disclose (as in prospectuses) should have full effect, notwithstanding section 995 of the Corporations Law and section 52 of the Trade Practices Act.[75]

The existing Corporations Law prospectus liability provisions are an integral part of the disclosure regime aimed at overcoming information imbalances in the securities market. They underpin the operation of the general disclosure test by providing those involved in the preparation of prospectuses with an

74 *Section 52 Trade Practices Act and Dealings in Securities*, September 1996, especially p 18.
75 *Financial System Inquiry Final Report,* Recommendation 4, p 252.

incentive to ensure full compliance. This is achieved by a combination of the threat of potential liability and the provision of defences encouraging compliance with the disclosure test, namely the carrying out of due diligence. It is significant to note that the information required under the general disclosure test is that known to the persons with statutory liability and the information which they can find out by making reasonable inquiries.

The balance struck in the Corporations Law between positive disclosure obligations and liability for non compliance is effectively undermined by the superimposed Trade Practices and Fair Trading Act liability.

The Trade Practices and Fair Trading Acts have an economy-wide consumer protection function. Strict liability, where it applies under those Acts, has the advantage of imposing liability on the person best placed to avoid the harm at the lowest cost. However, while this is consistent with having a liability regime which deters misleading conduct, it fails to adequately take into account the distinguishing characteristics of investing, the inherent function of which is allocating and pricing risk. As the FSI states:

> 'unlike the consumption of products or services in general, many investments provide a return to investors based on their bearing a share of the risks which are intrinsic to financial activity. This clearly distinguishes the act of investment from the act of consumption. Among the risks that investors may be rewarded for bearing are those deriving from imperfect information. It is vital to economic efficiency that regulation not unduly interfere with this risk allocation function of the financial system. In the areas of the law which have provided specific due diligence defences, explicit balances have been struck between consumer protection and market efficiency objectives, and these should not be interfered with by other laws'.[76]

Liability rules should not shift to fundraisers the investment risk properly accepted by investors in efficient securities markets. Investment in securities carries an inherent risk accepted by investors in order to receive the higher returns that such investments can bring. Imposing liability for failed investments on fundraisers regardless of fault either discourages capital raising at the outset or results in disproportionate due diligence and disclosure costs, ultimately borne by investors in increased prices for securities and lower returns. Reducing the return to investors will in turn dampen investment.

76 *Financial System Inquiry Final Report,* p 251.

A regulatory scheme involving positive disclosure obligations underpinned by specific liability provisions which include defences is consistent with a well recognised international approach to securities regulation.

For the above reasons, the strict liability regime of the Trade Practices Act and Fair Trading Acts should no longer apply to securities dealings.

The FSI identified the following alternatives for ensuring that the due diligence defences applied in respect of positive disclosure obligations:

- provide a due diligence defence in section 52 of the Trade Practices Act and other comparable legislation; or
- exclude actions for damages from the application of section 52 and the other legislation.[77]

The second option is preferable because it provides for a single statutory regime for capital raising. The consumer protection provisions of the Trade Practices Act and Fair Trading Acts should no longer apply to securities transactions.[78]

However, to ensure that there is no regulatory gap, the ACCC should be given the same standing as the ASC to enforce the relevant Corporations Law provisions where appropriate. Conduct involving dealings in securities would remain the responsibility of the ASC. Under this proposal, it is expected that the ACCC's role would be limited to taking action under the provisions only where a dealing in securities is an incidental aspect of the conduct in question. Arrangements would be put into place to delimit the roles of the two agencies.

The considerations suggesting that due diligence defences should apply in respect of statements made in a prospectus do not apply with the same force to statements made outside the prospectus which are not drawn from it. Those statements may, for example, be made in advertisements or oral presentations of the proposed venture. There are good reasons for those statements to be subject to strict liability under section 995 of the Corporations Law where they are misleading. These reasons include:

- the prospectus should be the primary source of information and issuers should not be encouraged to depart from or expand upon statements made in the prospectus;

77 *Financial System Inquiry Final Report,* p 252.
78 *Financial System Inquiry Final Report*, Recommendation 4, p 252.

- the mischiefs sought to be remedied by the removal of strict liability for statements in prospectuses are reducing the costs of due diligence investigations and reducing the length and complexity of prospectuses. These do not apply to statements made outside the prospectus; and
- the investor protection provided by section 995 for statements made outside a prospectus is lower than that provided by the prospectus provisions. In particular, liability is not collective. It is imposed only upon the person who *engages in* the misleading conduct,[79] whereas liability for statements made in a prospectus potentially extends to the corporation, its directors and the underwriter to the issue as well as professionals involved in making the particular statement. Further, it will in practice often be more difficult to prove that statements outside a prospectus were made and were relied upon.

Accordingly, there is not a case for applying due diligence defences in respect of statements made outside a prospectus.

Proposal No. 11 — Overlap between the Trade Practices Act and the Corporations Law

The liability rules for securities dealings should be contained in the Corporations Law. Section 52 and the associated consumer protection provisions of the Trade Practices Act (and the Fair Trading legislation of the States and Territories) should not apply to dealings in securities.

Other Financial Instruments

Consistent with the above proposal for fundraising, it is proposed that defences contained in the Corporations Law regarding takeover documents, and defences in the *Superannuation Industry (Supervision) Act 1993* regarding superannuation statements, should have full effect notwithstanding the Trade Practices Act. The exposure draft legislation giving effect to the proposals in this paper is expected to address this issue, should it proceed after consultation on the paper. This approach would be consistent with the FSI recommendation that defences associated with a positive duty to disclose should have full effect notwithstanding section 52 of the Trade Practices Act.

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79 *Yorke v Lucas* (1985) 158 CLR 661 at 666.

Who Should be Liable for a Defective Prospectus?

In the ordinary course, the corporation and its directors are closely involved in the assessment of the corporation's financial position and prospects and the formulation of the plan to raise funds. The same is true of the underwriters of an issue. This core group of people are in the best position to include in a prospectus, from their own knowledge or by inquiry, the information which investors need to know in order to make an informed decision whether to invest in the securities offered. They can ensure in a cost-effective manner that the prospectus is complete and accurate.

It is appropriate to retain the liability of the persons mentioned above because of their significant role in the prospectus process and the incentive created by that liability to comply with the disclosure regime. Accordingly, the Corporations Law should continue to make this core group liable in damages for all statements and omissions in a prospectus (subject to the uniform defence discussed below).

The Law currently includes stockbrokers to an issue amongst those persons liable for the prospectus as a whole. That is appropriate if they are underwriting the issue, but not otherwise. Stockbrokers who are not underwriting the issue may play a limited role and their responsibility should be the same as for other professional advisers (discussed below). Of course, if the stockbrokers are underwriting the issue, they should be liable for the whole prospectus in their capacity as underwriters.

The Law currently allows underwriters to limit their responsibility to part only of the prospectus.[80] This limitation is inconsistent with their role in relation to preparing and marketing prospectuses and should not be retained.

Overseas Experience

In the United States, United Kingdom, Ontario and New Zealand, the corporation and its directors are liable in respect of a defective prospectus. Of these jurisdictions, Ontario and the United States specifically make underwriters liable.[81] Stockbrokers to the issue are not liable as such, but in the

80 Corporations Law, section 1010. This section also applies to stockbrokers to the issue, but such persons would no longer have general responsibility under the proposals in this paper.

81 Ontario Securities Act, paragraph 130(1)(b); Securities Act, section 11.

United States they will be liable to a customer to whom they actively promote stock.[82]

Proposal No. 12 — Persons Liable for all Statements in a Prospectus

The corporation, its directors and the underwriters of an issue should be liable to investors for misleading statements in a prospectus (subject to the uniform defence described below).

In addition to these categories, the Corporations Law also includes *promoters* in the class of persons responsible for all statements in the prospectus (subject to due diligence defences). The range of people who might be promoters is unclear. While the statute provides some guidance by excluding professionals and business persons engaged to assist the corporation, as well as persons who were not party to the preparation of the prospectus,[83] the category of promoter has not been exhaustively defined by the Corporations Law or the courts and is of uncertain width.[84]

The Law also currently makes persons who 'authorise or cause the issue of' a prospectus responsible for all statements in it (subject to due diligence defences).[85] This category of liability could give rise to uncertainty as to whether majority shareholders, professional advisers, or others associated with the fundraising will have responsibility for the prospectus as a whole.

82 Securities Act, section 12.

83 See the definition of 'promoter' in section 9 of the Corporations Law.

84 In *Elders Trustee v Reeves* (1987) 78 ALR 193 at 234, Gummow J considered that the question of whether someone is a 'promoter' is determined by asking whether 'the facts showed the establishment of such relations between the alleged promoter and the birth, formation and floating of the business enterprise in question as to render it contrary to good faith that the alleged promoter should retain from the promotion a secret profit, or, one might add, that he should refuse restitution for loss inflicted by him by preferring his interest to his duty.' That decision was made under the general law rather than companies legislation but his Honour also stated (though it was not necessary to his decision) that 'The Code [predecessor to the Corporations Law] contains, for its purposes, a definition of 'promoter' (section 5(1)), but it is a limited one and not of direct assistance in this case; plainly it assumes reference will be made to the meaning of the expression as developed in equity.' The definition in the Companies Code was retained in the Corporations Law without material amendment.

85 Corporations Law, sections 996, 1005 and 1011.

The law provides sufficient regulation of persons who might be described as promoters or as 'authorising or causing the issue of' a prospectus without including them in the category of persons responsible under the Corporations Law for all statements in the prospectus. A person who is not formally appointed as a director will nevertheless have responsibility as a director if their involvement in the activities of the company is such as to make them a *de facto* or shadow director.[86] In that case they will fall within the core group of persons liable on the prospectus under the Corporations Law. Whether or not they are a director, they will have responsibility to investors if they participate in a contravention of the prospectus disclosure requirements with a guilty mind.[87] They may also be liable under the general law as fiduciaries.[88]

The Corporations Law should impose general responsibility for the prospectus only on those who should properly accept responsibility for due diligence and settling the prospectus: the corporation, directors (including *de facto* and shadow directors) and the underwriters of the issue. The Law should not encourage others to participate in the due diligence process. That role should be exclusive to the core group of persons discussed above and any persons that *they* engage or consult for the purpose. Promoters, for example, are not supposed to be managing the corporation and often will (by definition) have serious conflicts of interest making it inappropriate that they interfere in that process.

Removing the existing liability under the Corporations Law of promoters and persons who 'authorise or cause the issue of' a prospectus will avoid uncertainty, focus liability on those who should control the fundraising process and reduce compliance costs. Promoters and persons who 'authorise or cause the issue of' a prospectus will remain liable if they are *de facto* or shadow directors or if their involvement is such as to attract liability for fraud or under the general law.

Overseas Experience

New Zealand makes promoters liable[89] while the United States, United Kingdom and Ontario do not. In the United Kingdom, persons who

86 Corporations Law, section 60.

87 Corporations Law, sections 79 and 1005. The test is the same as under section 75B of the Trade Practices Act, addressed in *Yorke v Lucas* (1985) 158 CLR 661.

88 See *Elders Trustee v Reeves* (1987) 78 ALR 193 and note other equitable doctrines such as accessorial liability discussed by Gummow J at 238-9.

89 Section 2 of the New Zealand Securities Act defines a promoter as 'a person who is instrumental in the formulation of a plan or program pursuant to which securities are offered to the public, and directors of body corporate promoters. The term 'promoter' does

'authorise' part or all of the contents of a prospectus are liable in respect of those contents.[90]

Proposal No. 13 — Promoters

The persons liable under the Corporations Law for a misleading prospectus should not include promoters or persons who 'authorise or cause the issue of' the prospectus, unless they are liable as directors or in some other capacity.

Professional Advisers and Experts

In the course of preparing a prospectus, a corporation and its directors will usually engage professional advisers (such as lawyers and merchant bankers) to give advice about the prospectus as a whole. They often play a major role in drafting prospectuses and participating in due diligence committees.

Professional advisers are liable for statements or omissions for which they are 'responsible' in their 'capacity as' professional advisers.[91] It is not clear whether this liability is limited to statements of opinion on specific matters which are expressly attributed to them in the prospectus or whether it extends to all parts of the prospectus which they have advised or assisted on. Given that they may be liable in relation to the broader role arising from their participation in the preparation of a prospectus and, in particular, the due diligence process, it is likely that professional advisers adopt a cautious approach by assuming that they may be joined in any action on a misleading prospectus and may be found liable for any defects. They may therefore seek to verify parts of the prospectus which they would not otherwise consider (and which may not fall within their professional expertise) and ensure that all parts of the prospectus make very detailed disclosure. This would in turn contribute to the cost of undertaking due diligence and could contribute to the length and complexity of the prospectus. The Law should be clarified to limit the liability of professional advisers to specific statements in the prospectus for which they accept responsibility. For the reasons given above, this reform should also apply to stockbrokers to an issue where they are not underwriting the issue.

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not include directors and officers of the issue and persons acting solely in their professional capacity'.

90 Financial Services Act, paragraph 152(1)(e).

91 Corporations Law, paragraphs 1009(2)(b) and (4)(c).

The Law currently requires the issuers of a prospectus to obtain an expert's consent before attributing any statement to them.[92] There is no reason to restrict this provision to experts. The consent of professional advisers should be required as well.

Experts, such as investigating accountants and geologists, are currently liable for the specific expert opinions attributed to them in the prospectus with their consent. This reflects their role and responsibilities and is consistent with the above position proposed for other professional advisers. It is appropriate to retain the current rule.

Overseas Experience

In key overseas jurisdictions, professional advisers and experts are generally not liable except in respect of their statements in a prospectus.

Proposal No. 14 — Professional Advisers and Experts

Professional advisers and experts should be liable to investors only for misleading statements attributed to them in the prospectus (subject to the uniform defence described below). Issuers should be required to obtain the consent of professional advisers and experts before attributing statements to them in the prospectus.

Defences for Defective Prospectuses

For the reasons outlined above, it is appropriate to have defences available to persons who, notwithstanding a lack of fault on their part, have nevertheless failed to make full disclosure in the prospectus. Under the current rules in the Corporations Law, different but similar defences apply to different persons associated with a prospectus. Directors, experts and most advisers have a defence if they made reasonable inquiries and reasonably believed the prospectus was not misleading.[93] On the other hand, the corporation, stockbrokers and underwriters have a different defence. They must show that the misleading statement was due to:

- a reasonable mistake;

92 Corporations Law, section 1032.
93 Corporations Law, sections 1008A and 1009.

- reasonable reliance on information supplied by another person (other than their director, servant or agent); or
- the act or default of another person (other than their director, servant or agent) or an accident or some other cause beyond their control provided (in each case) they took reasonable precautions and exercised due diligence to ensure that the prospectus was not misleading.[94]

It is confusing and unduly complicated to have different defences for different categories of person associated with prospectuses. Giving the corporation, directors, underwriters, experts and advisers (including stockbrokers) the same defence to a damages action would assist in ensuring a simple, comprehensive and uniform set of rules applying to those primarily involved in the preparation of a prospectus. This in turn will reduce compliance costs, in particular the legal costs of advising on due diligence responsibilities.

The defence should enable defendants to rely upon advice from experts and others (except their own employees) where that is reasonable. If the advice being relied upon is from a person who is not named in the prospectus, investors may be unable to recover their losses from any person (unless they can prove fraud). However, it would be out of step with international standards (and encourage excessive due diligence) to make unnamed advisers liable to investors or to make directors and others strictly liable for the mistakes of their advisers. Unnamed advisers may of course be liable to the corporation (if not investors) if their advice is negligent.

The current exemptions from liability for persons who have not given their consent to the prospectus or the defective statement in it should be retained.[95]

Overseas Experience

In the United Kingdom, United States and Ontario, a uniform defence operates along the same lines as the Australian defence for directors, experts and most advisers. In New Zealand, only limited defences are available. Experts have a defence (in respect of statements which they were competent to make and reasonably believed to be true) while others have a defence in respect of statements made by experts provided they reasonably believed them to be true.[96]

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94 Corporations Law, section 1011 (based on the defence contained in section 85 of the Trade Practices Act).

95 Corporations Law, sections 1006(2), 1008, 1009(3)-(4), 1010(1)(b).

96 Securities Act, sections 56 and 57.

Proposal No. 15 — Uniform Defence

A defence should be available to the corporation, directors, underwriters, experts and advisers where they prove that they made such inquiries (if any) as were reasonable, took reasonable care and it was reasonable for them to have believed that the prospectus was not misleading. They should be entitled to rely upon other persons (such as professional advisers and experts) where that is reasonable.

4.2 Small Business

The existing prospectus provisions potentially impose disproportionately high costs on SMEs. To the extent that this is a barrier to SME financing, it inhibits market and employment growth.

Regulatory Framework

The prohibition on offering securities of a corporation for subscription without a prospectus applies to offers of securities in SMEs in the same way as it does to other corporations.[97]

However, exceptions exist and two of these are particularly relevant to small fundraisings by SMEs:

- *the 20 offers of securities in 12 months exception:* an offer to take up securities (other than prescribed interests) may be made personally to up to 20 investors in a 12 month period without the need for a prospectus;[98] and
- *the sophisticated investor exception:* a prospectus is not required for investors investing at least $500,000 in the issue.[99]

Other exceptions are available[100] and, in addition, the ASC has a discretion to make individual or class exceptions from the fundraising provisions.[101] For

97 Corporations Law, section 1018.
98 Corporations Law, paragraph 66(3)(d) and see Corporations Regulations, regulation 7.12.04 for joint ventures and trusts with 15 or fewer participants.
99 Corporations Law, paragraph 66(3)(a).
100 See Corporations Law, section 66 and Corporations Regulations, Part 7.12.
101 Corporations Law, section 1084.

example, the ASC has recently issued for comment a proposal that, subject to conditions, it should modify the Law on advertising and disclosure to facilitate business matching services which introduce investors to SMEs seeking up to $5 million (before the preparation of any prospectus required for the fundraising).

Relevance of Small and Medium Sized Enterprises to the Economy

SMEs[102] are central to the viability of the Australian economy.[103] A recent Industry Commission report on informal equity investment cited research indicating that SMEs play a particularly valuable role in the economy, because small firms:

- are better able to adjust output levels when demand fluctuates over time; and
- may have superior access to some scarce factors of production (eg specialised knowledge or ability to serve a particular market well).[104]

In the interests of promoting economic growth and national wealth, employment growth and export earnings, impediments to the development of SMEs should be identified and removed.

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102 There is no uniformly recognised definition of SMEs. The Small Business Deregulation Task Force identified the characteristics of small business as independently owned and operated, most capital contributed by owners and managers, closely controlled by owner/managers who make principal decisions, and having a turnover of less than $10 million. The Task Force noted that most small businesses have less than 20 employees in non-manufacturing industries and less than 100 employees in manufacturing industries: Small Business Deregulation Task Force, *Time For Business*, November 1996, p 13. See also Australian Bureau of Statistics, *Small and Medium Enterprises: Business Growth and Performance Survey*, September 1997, pp vii-viii.

103 The National Investment Council's report, *Financing Growth: Policy options to improve the flow of capital to Australia's small and medium sized enterprises*, August 1995, p 9, noted that SMEs:

- are overwhelmingly the numerically dominant form of business;
- account for around 40 per cent of private-sector output and almost half of private employment;
- have generated more than half the employment growth in recent years; and
- over 80 per cent of Australia's manufacturing exporters and 65 per cent of service exporters are SMEs.

See also Part 2 of this paper.

104 Industry Commission, *Informal Equity Investment: Small Business Research Program*, Information Paper, April 1997, p 3 (citing research of Brock and Evans, 1989).

Access to Finance

An important aspect in promoting the growth of SMEs is ready access to external finance. Generally, smaller firms would prefer to rely on their own internal resources rather than be constrained by debt or lose or dilute control by introducing equity partners or issuing securities to the public. However, an SME experiencing high growth may have capital demands that cannot be sufficiently serviced through retained profits and borrowings and will therefore need to seek investment from private or institutional investors.

The National Investment Council report identified the difficulties that SMEs have in accessing investment capital as a major barrier to their growth. Impediments to SME capital raising which were identified included:

- inefficiencies in the SME capital market, including a lack of cost-effective information required by both SMEs and potential investors to assess the viability of investment proposals. In particular, SMEs must incur up-front costs in preparing financial data and business plans for potential investors and may need to tailor this information according to the requirements of each potential investor;
- SMEs typically not being investment-ready, because they lack appropriate governance arrangements, are *key-person driven* (that is, the business is not sustainable in the absence of the 'owner') and lack adequate business management skills; and
- SMEs prefer to keep the business relatively closely-held and are therefore reluctant to accept investors who may wish to actively participate in management.[105]

The FSI identified the following difficulties experienced by SMEs in obtaining funds:

> '• Scale — more than 90 per cent of SMEs seeking growth finance require less than $500,000 — the fixed costs involved in searching, assessing and monitoring a loan make it disproportionately more expensive to provide funds to an SME;
>
> • Risk — SMEs are perceived to be higher-risk propositions. Start-ups and high-growth firms often lack a track record; and

105 National Investment Council, *Financing Growth: Policy options to improve the flow of capital to Australia's small and medium sized enterprises*, August 1995, pp 27-31. The report also refers to a Yellow Pages survey which suggests that 'only an estimated 2 per cent of all Australian small businesses are growth firms currently seeking external equity', p 19.

- Reporting — SMEs frequently have difficulty providing good quality information, and media or stockbroker reports are rarely available.'[106]

Problems Encountered by SMEs seeking Equity Investment

It is commonly asserted that the cost of issuing a prospectus for SME fundraising is excessive.

Not all of the costs incurred in offering securities are attributable to the preparation of a prospectus. Many costs that may be associated with the preparation of a prospectus, such as the cost of establishing the financial position of the company and of putting in place appropriate financial and reporting systems, would need to be incurred in any event.

However, a recent report illustrates the high relative cost of small business fundraising associated with listings on the ASX. Floats between $2 million and $4 million incurred direct costs of between 9 per cent and 43 per cent, and generally exceeded 10 per cent of the total raising. In comparison, floats over $5 million incurred costs consistently below 10 per cent.[107] The report concluded from these figures that there was a substantial fixed-cost element in obtaining a listing.

While there is little data available, it is likely that the cost of preparing a prospectus would be a strong disincentive to an SME seeking to raise equity to expand its business or reduce debt. Passing such costs on to investors will also increase the price of the securities on offer which may deter investment.

The question to be addressed is how to improve SME access to the capital market while still retaining appropriate protection for investors in SMEs and not undermine market integrity. It is proposed that an appropriate balance can be struck by:

- permitting the limited use of disclosure documents with less onerous content requirements than a prospectus, provided that appropriate risk warnings are made;

106 *Financial System Inquiry Final Report*, p 510.

107 CipaNet International, *A Study on the Cost of Small Entities Obtaining and Maintaining an Official Listing on the Australian Stock Exchange*, November 1996, p 7.

- providing a complete exemption from the prospectus provisions for essentially private business arrangements involving relatively small sums where regulatory intervention is not justified; and
- providing a complete exemption for offers made to persons who could be expected to make an informed investment decision on a cost-effective basis without regulatory intervention.

These aims are furthered by the following three proposed exemptions from the prospectus requirements of the Law.

a) Exception for Fundraisings up to $5 Million accompanied by an Offer Information Statement

Provided the market is made aware of the risks associated with investment in SMEs and accepts those risks in expectation of higher returns, SME fundraising should be allowed at commercially viable compliance costs.

In order to achieve this, SMEs should be able to raise up to $5 million by way of an OIS instead of a prospectus. They should be able to raise funds in this way only once. The disclosures required by an OIS would be significantly less than those required by a prospectus. In particular, it would only be necessary to disclose material information already within the knowledge of the corporation and its officers.

A limit of $5 million would comfortably accommodate the fundraising targets of most, if not all, SMEs. Issuers seeking larger amounts of capital could be expected to reasonably bear the costs of prospectus preparation and pass such costs on to the investors without making the offer price unattractive. Hence the rationale for reduced regulation does not apply in the case of larger fundraisings.

Disclosure Obligations

An OIS would need to include:

- basic information identifying the corporation and the securities on offer;
- a description of the corporation's business;
- information about how the business is to be progressed;
- other material information known to the corporation;
- any further disclosures required by regulation; and

- audited accounts, prepared within the previous six months, in order to give investors an accurate assessment of the corporation's financial position. Larger SMEs may already have these accounts available because of the requirement for audited accounts to be lodged with the ASC.[108]

An OIS should also include a prominent statement that:

- an OIS is not a prospectus;
- an OIS requires a lower level of disclosure than a prospectus;
- investments made on the basis of an OIS may be more risky than investments made under a prospectus; and
- investors should seek professional investment advice prior to making an investment decision.

These warnings would be particularly important in ensuring that inexperienced investors are made aware of the risks involved in an OIS offering. While the facilitation of SME fundraising justifies some modification of the prospectus provisions, this should not occur at the cost of investor protection.

The disclosure obligations under an OIS would be limited to material information known to the corporation. This would be a substantially less onerous disclosure obligation than the current general disclosure test because it would not be necessary to undertake external inquiries to ascertain information about the matters on which disclosure is required. Corporations and their officers would not be liable if their OIS disclosed all material information within their knowledge. Inquiries could therefore be limited to determining what information is already known to the corporation and its officers. Investment-ready SMEs should already have in place sufficient internal reporting and information systems to minimise the cost of these checks,[109] and should have already prepared a business plan in anticipation of inviting external equity investment.

In light of the positive disclosure obligation involved in an OIS, it is envisaged that due diligence defences (adapted to reflect the more limited disclosure obligations) would be available in respect of liability arising under an OIS offering. The liability of others involved (including professional advisers and

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108 Corporations Law, Part 3.7.

109 National Investment Council, *Financing Growth: Policy options to improve the flow of capital to Australia's small and medium sized enterprises*, August 1995, p 19.

experts) should be limited to statements and opinions included in the OIS with their consent.[110]

The use of an OIS should be restricted to once only in an organisation's lifetime. The justification for this is that the OIS would assist SMEs obtaining the start up capital to pass through the equity gap.

Anti-avoidance provisions should be introduced into the Law to prevent corporations artificially structuring fundraisings in order to fall within the exception.

Interaction with Other Fundraising Rules

The Corporations Law rules for fundraising (as modified by the proposals in this paper) would apply to fundraisings undertaken using an OIS. In particular, the rules requiring lodgment with the ASC and imposing restrictions on advertising securities would apply to an OIS offering.

The total funds which could be raised by an OIS offering would be limited to $5 million, but exempt issues would not be counted towards this total. Other amounts could be raised under the 20 issues in 12 months exemption or from sophisticated investors who do not require prospectus disclosures (addressed below).

Overseas Experience

Reduced disclosure requirements for small scale offers have been utilised in the United States[111]. Their use in Canada has recently been recommended by the Ontario Securities Commission Task Force on Small Business Financing.

110 See the discussion on liability in section 4.1 above.
111 SEC Forms SB1, SB2, SB3 and Regulation A.

Proposal No. 16 — Fundraising up to $5 Million under an Offer Information Statement

A corporation should be able to raise up to $5 million based on an OIS, without preparing a prospectus. In an OIS, the corporation would state what the funds are required for and disclose material information already known to it, but the corporation would not need to undertake due diligence inquiries or commission experts. The OIS would warn investors of the risks of investing without a prospectus and the desirability of obtaining professional investment advice. The OIS would also include audited accounts. The liability and other rules applicable to prospectuses would apply to an OIS subject to appropriate modifications to account for the reduced disclosure. A corporation or enterprise would only be able to issue one OIS in its life.

b) Exception for 20 Issues in 12 Months

Fundraising based on personal offers made to a small number of investors and for the purpose of raising a relatively small amount of capital should be free of mandatory disclosure requirements. Personal offers are offers to persons who have indicated their interest in offers of that kind or who are likely to be interested in the offer as a result of previous contact, or a professional or other connection, with the person making the offer.

To accommodate SME fundraising involving only a limited investment by a limited number of investors, a fundraising should be exempt from the requirement for either a prospectus or an OIS if no more than 20 issues of securities are made in a rolling 12 month period, based on personal offers of those securities, and no more than $2 million is to be raised. Issues that are otherwise exempt from the prospectus requirement would not be counted in the 20. This proposed exception is based on a major reformulation of the existing 20 personal offers in 12 months rule, which it would replace.

SMEs are much more likely to achieve their funding targets from 20 issues of securities than from 20 offers (all of which may be rejected). Furthermore, it is easier to determine whether 20 issues have been made because each subscription is documented. Hence the proposed new rule would be more workable.

The FSI recognised the proposal to move from a 20 offers rule to a 20 issues rule as a practical measure to reduce the cost of capital raising for smaller entities without diminishing investor protection.[112] The Industry Commission has also recently recognised the desirability of this proposal, noting that it would remove a substantial uncertainty currently facing SMEs seeking informal direct investment.[113]

In order to ensure that an OIS or prospectus is still required where it is commercially viable for the fundraiser to prepare one, it is proposed that the Law be changed so that the total amount which may be raised under this exemption each year be limited to $2 million. The exception needs to be targeted at genuine SMEs, not companies with sufficient assets and raising sufficient funds for disclosure (in an OIS or prospectus) to be commercially viable and appropriate. The absence of a cap would mean that an unlimited amount of funds could be raised from 20 investors, none of whom would have received the disclosure which it was cost-effective for the issuer to make.

Anti-avoidance measures should be included in the Law to prevent the same enterprise being financed by several corporations each of which are funded by 20 investors.

Overseas Experience

Limited offer exclusions from the prospectus provisions are utilised in the United Kingdom,[114] the United States[115] and Canada.[116]

Proposal No. 17 — Fundraising by Personal Offers

A corporation should not need to prepare a prospectus or OIS to raise up to $2 million each year from 20 or fewer persons who have indicated their interest in offers of that kind or who are likely to be interested in the offer as a result of previous contact or a professional or other connection with the person making the offer. While the number of subscribers would be limited to 20, they could be drawn from a larger pool of persons to whom offers are made.

112 *Financial System Inquiry Final Report*, p 268.
113 Industry Commission, *Informal Equity Investment: Small Business Research Program*, Information Paper, April 1997, p 70.
114 Public Offers of Securities Regulations, paragraph 7(2)(b).
115 Securities Act, Regulation D.
116 Ontario Securities Act, section 72.

c) Sophisticated Investor Exemption

Certain investors are seen to be financially sophisticated and able to protect their investment interests in an optimal fashion without regulatory interference. These investors do not require the disclosure protection offered by the Corporations Law. They can secure their own cost-effective protection in negotiations with the issuer. Issuers making offers to such persons should not need to incur costs beyond those negotiated between the parties. Sophisticated investors should not be burdened by unwanted costs being incorporated in the price of the securities on offer.

The current *sophisticated investor* exemption applies only to a person who invests over $500,000 in the securities in question. Such a person is thought not to need the protection of mandatory prospectus disclosures under the Corporations Law, based on their ability to obtain pertinent information from the issuer because of their bargaining power and proximity.

However, the need to invest so large an amount in an individual enterprise for which there is not a prospectus may of itself be a deterrent to investing, given the potential risks and the difficulty this causes for investors in diversifying their portfolio (unless they have very significant resources). From an issuer's perspective, the $500,000 threshold may therefore be too high because of the difficulty of finding investors willing to invest such large sums.[117] Many SMEs would in any event be seeking less than $500,000 in total.

To overcome this problem, a new sophisticated investor threshold is proposed in addition to the existing $500,000 exemption. Under this proposal, such investors would be able to invest less than $500,000. Offers of securities in any amounts should be permitted without a prospectus if they are made to persons:

- with gross income over each of the previous two financial years of at least $250,000; or
- with net assets of $2.5 million.

This includes all investors who may reasonably be assumed to be sophisticated and not in need of regulatory interference in their business

117 This problem was highlighted by the Industry Commission, *Informal Equity Investment: Small Business Research Program*, Information Paper, April 1997, p 29, which found that of the businesses surveyed 1.7 per cent of all businesses with less than 20 employees had received equity from a business angel some time in the last few years. Of these investments made by business angels, only 6.2 per cent of these investments were above $500,000.

transactions. The proposal is not limited to investment in SMEs but will be of the greatest advantage to small business seeking to raise funds from so-called business angels.

In determining the income threshold under the proposed reform, investors would be able to produce to the issuer either their taxation assessment for the previous two financial years or (if they wished to retain confidentiality) their accountant's certification that they satisfy the income bracket. In order to determine the net assets of an investor, the investor would have to obtain certification from their accountant confirming that they fall within the exemption. Formal certification of an investor's qualification would provide evidence of the basis of the transaction and would ensure that those investors not provided with regulatory protection were limited to sophisticated investors.

In order to ensure that the sophisticated investor exemption accurately reflects the investor's current position, certification would only be valid for one year but could be renewed.

Expansion of the sophisticated investor exemption in the manner proposed would have the advantage of allowing genuinely sophisticated investors to invest any amount they wish. This amount may be well below $500,000. This would allow for investment in small amounts in a larger number of businesses.

Overseas Experience

This approach is comparable to the law in the United States and recent recommendations made by the Ontario Securities Commission.[118]

118 Ontario Securities Commission Task Force, *Small Business Financing*, Final Report, October 1996, p 42.

Proposal No. 18 — Sophisticated Investors

Issuers should be free to raise funds from sophisticated investors without preparing a prospectus or OIS. Sophisticated investors are those:

- who are investing at least $500,000 in the issue;
- who have net assets of $2.5 million; or
- whose gross income in the previous two years was at least $250,000 per annum.

Overall Benefits from Proposed SME Reforms

The reforms to SME fundraising outlined in this paper would operate as a package involving different approaches, depending on the equity capital raising needs of an enterprise at a particular stage of its development. If issuers need access to up to $2 million then this may be achieved without regulatory interference, other than the prohibition in section 995 of the Corporations Law on misleading and deceptive conduct and other general purpose regulations, by making up to 20 personal issues in 12 months. Where between $2 million and $5 million is required from persons who do not fit the sophisticated investor categories, the funds may be raised in a cost effective way with an OIS. Where more than $5 million is required from persons who do not fit the sophisticated investor categories then a prospectus will be needed. Where the capital sought by an SME can be obtained from one or more sophisticated investor then there would be no mandatory disclosure requirement.

Investors would retain the benefit of the existing protection against false and misleading conduct.[119] The insider trading rules will also assist in protecting prospective investors.[120]

The proposed reforms would operate against the background of further relief from the Law provided by the ASC to encourage small business. It is not practicable for the Corporations Law to address all scenarios in which an SME should be free of some or all regulatory interference in raising capital. That is why the ASC is given the power to modify the fundraising provisions of the

119 Corporations Law, section 995.
120 Corporations Law, sections 1002-1002U.

Law in appropriate cases. It would, for example, be appropriate for the ASC to grant relief to enable SMEs to issue shares to their employees without regulatory interference where the issue is made as a low or no-risk incentive to increase productivity rather than to raise capital. Whether particular employee share schemes or other small business securities transactions warrant relief from the Law beyond the SME reforms proposed above is a matter best left to the regulator to determine on a case by case basis.

4.3 Electronic Commerce

The use of electronic technology has the potential to reduce fundraising costs as well as improve the pace with which up-to-date information is provided to investors. However, there are statutory impediments to its use.

Regulatory Framework

The Corporations Law generally permits documents to be in electronic form.[121] However the fundraising provisions arguably assume the use of paper prospectuses, by requiring that all directors sign a prospectus.[122]

The distribution of prospectuses electronically is also currently impeded by the restriction on sharehawking, which generally prohibits sending a prospectus to investors in different places by electronic means.[123]

Facilitating Electronic Commerce

The FSI noted that existing regulation has created barriers to electronic commerce in certain areas because it is 'predicated on paper or physical transactions'.[124] The FSI expressed the view that the law 'should not differ between different technologies or delivery mechanisms such as to favour one technology over another'.[125]

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121 See the definition of 'writing' in section 9 of the Corporations Law.
122 Corporations Law, subsection 1021(13).
123 Corporations Law, subsection 1078(3A). There are exclusions for licensed dealers making offers to existing clients.
124 *Financial System Inquiry Final Report*, p 501.
125 *Financial System Inquiry Final Report*, Recommendation 91, p 502.

a) Lodgment of Electronic Prospectuses with the ASC

Provided a prospectus complies with the disclosure test,[126] issuers should not be constrained from using interactive methods of communicating an offer to assist investors in assessing the merits of the offer. Electronic prospectuses would enable investors to find information through the use of a simple search facility. They could use hypertext links to other parts of the prospectus or to audio or video presentations, animated graphics and other non-text based ways of communicating information to potential investors.

The agreement of the regulator would be required to use this form of prospectus because of the need to ensure that lodged electronic prospectuses are in a form that is compatible with the regulator's computer systems. The regulator would also need to be satisfied about authentication of the prospectus and protection against unauthorised alteration.[127]

b) Electronic Distribution of Prospectuses

The current sharehawking prohibition prevents the sending of prospectuses to investors using electronic communications except by a licensed dealer (where permitted).

The justification for the sharehawking prohibition under the Corporations Law rests on the undesirability of unsolicited personal contact with potential investors. This prohibition is based on the possibility of high pressure sales of securities. This justification applies to personal contact, whether face to face or by telephone. However, the undesirable features of sharehawking do not extend to prospectuses sent by post or other means which do no involve personal contact. Electronic distribution of prospectuses (for example, via e-mail or the Internet) should be permitted.

Overseas Experience

Electronic distribution of prospectuses is permitted in the United States and New Zealand, but not in the United Kingdom. In Ontario, the Toronto Stock Exchange has recently recommended that issuers should provide access to their prospectuses by making them available through computer connections,

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126 Corporations Law, section 1022.
127 The issue of lodgment of documents with the regulator and contemporaneous payment will be examined in the CLERP — Electronic Commerce Paper.

for example, by including the prospectus on their website.[128] This issue is now being examined by the Ontario Securities Commission.

Proposal No. 19 — Electronic Commerce

Issuers should be able to issue prospectuses in electronic form and distribute them through the Internet or other media.

128 Toronto Stock Exchange, *Responsible Corporate Disclosure*, March 1997, Recommendation 7.13.5, p 77.

PART 5: OTHER ISSUES

The issues of prospectus registration and governmental immunity are addressed in detail below and proposals for reform are advanced.

5.1 REGISTRATION OF PROSPECTUSES

The registration of prospectuses may create the false impression of ASC approval of the contents of the prospectus. Also, while a prospectus is being examined by the ASC for registration, the market does not have access to it.

Regulatory Framework

Most prospectuses must be registered with the ASC. The exceptions relate primarily to securities traded on the ASX, and offers to existing shareholders and employees of listed or approved corporations.[129]

The ASC must register a prospectus as soon as possible after it is lodged and in any event within 14 days.[130] The ASC must refuse to register a prospectus if it appears that it does not comply with the prospectus content requirements of the Law. The ASC has the power to issue a stop order, directing that no further securities be issued under a particular prospectus if it does not comply with the Law.[131]

Should Registration be Required?

In practice, the ASC only examines prospectuses in a limited manner prior to registration unless it considers that a closer examination is justified. Its policy is to refuse registration only where it considers there are obvious errors in the

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129 Corporations Law, subsection 1017A(3). Subsection 1017A(4) of the Law provides an exemption in respect of certain managed investment schemes.

130 Corporations Law, subsection 1020A(1) and Corporations Regulations, regulation 7.12.08.

131 Corporations Law, section 1033.

prospectus.[132] The ASC also relies on its stop order power to conduct post-registration vetting designed to improve compliance.

The period taken by the ASC to register prospectuses has reduced significantly since 1991, consistent with the move away from pre-vetting. In 1995-96, 54 per cent of prospectuses were registered within 3 days.[133] For that year, the ASC refused to register approximately 12 per cent of the prospectuses lodged for registration.[134]

The system of registration can result in the misconception that the ASC has endorsed a prospectus. Furthermore, the time taken for registration does not benefit the market generally as it does not have access to the document until after registration. Hence the media, market analysts and others do not have a period prior to the issue of the prospectus to consider it and make appropriate comment to the market or the ASC.

Instead of the current registration system, it would be preferable for there to be a 14-day delay between the lodgment of the prospectus and fundraising under it. In that way the responsibility for prospectuses would clearly be with the issuer. The regulator would still have a reasonable opportunity to issue a stop order preventing fundraising under a defective prospectus. Furthermore, the market generally would have an opportunity to consider the prospectus before the commencement of subscriptions for the securities on offer. Where the prospectus was defective, the market could draw matters to the attention of the regulator and aggrieved parties could, if appropriate, seek injunctions preventing the fundraising.

Accordingly, the existing registration process should be replaced by a system under which:

- prospectuses which currently require registration need only be lodged with the ASC;
- for 14 days after lodgment, no offers of securities may be made on the basis of the prospectus;
- the prospectus is available from the ASC immediately on lodgment; and
- after 14 days, securities may be offered on the basis of the prospectus unless the ASC issues a stop order or a court order is made.

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132 ASC, *Annual Report 1995-96*, p 27.
133 This information was provided by the ASC.
134 These figures were provided by the ASC and do not include prospectuses which were withdrawn or altered as a result of ASC queries.

Proposal No. 20 — Registration

Prospectuses should no longer need to be registered by the ASC, but subscriptions should not be allowed until 14 days after lodgment with the ASC.

5.2 GOVERNMENTAL IMMUNITY

The capacity of the Commonwealth, States and Territories to offer securities without complying with the fundraising provisions has been widely criticised as being inconsistent with best modern commercial practice.

Regulatory Framework

The Commonwealth, States and Territories are currently exempted from the operation of the fundraising provisions. This immunity generally extends to agents and private parties engaged by government to assist in carrying out the transaction.[135]

Competitive Neutrality

Governments have increasingly sought to privatise their business enterprises. The immunity creates an uneven playing field. It potentially leads to distortions in the securities market through a lower standard of disclosure to investors. Governmental immunity precludes an investor from obtaining relief under the Corporations Law for loss caused by inadequate disclosure.

The fact that the Corporations Law does not apply may operate to the disadvantage of governments wishing to issue equity securities. Investor confidence in such an issue may diminish if there is uncertainty as to whether the disclosure and the available remedies for inadequate disclosure are at the same level as those applicable in the private sector. This in turn may lower the price that can be obtained for the securities. In addition, the absence of a complying prospectus may inhibit sales through overseas markets (because

135 See *Corporations Act 1989*, section 17; *Corporations ([name of State]) Act 1990*, section 15; ASC Practice Note 62*, Crown Immunity and Privatisations*, 20 May 1996.

overseas jurisdictions commonly require there to be a complying prospectus in the home jurisdiction).

The issue of how to avoid the problems caused by governmental immunity has arisen in a number of government privatisations where, for marketing reasons, governments have sought to take advantage of having a prospectus which complies with the Corporations Law. This has occurred in some cases through the inclusion of an express contractual adoption of the Corporations Law rules.

In order to bring the partial sale of Telstra under the Corporations Law, section 8AT of the *Telstra (Dilution of Public Ownership) Act 1996* applies the fundraising rules to the Commonwealth and enables the prospectus to be registered by the ASC.

The operation of governmental immunity in the companies and securities field generally was criticised in a report by the Senate Standing Committee on Legal and Constitutional Affairs.[136] The Committee noted that the continued application of governmental immunity in commercial contexts was inconsistent with the objectives of national reform in the public sector. Where governments engaged in purely commercial activities and competed with private enterprise, the Committee considered that it may be desirable to eliminate the operation of the governmental immunity altogether.

Maintenance of the current immunity for government fundraising would be inconsistent with the principles of competitive neutrality agreed by the Commonwealth, State and Territory Governments, arising out of the *National Competition Policy* report.[137] This is reflected in the *Competition Principles Agreement* which endorses 'the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities'.[138]

Competitive neutrality is part of broader economic policies aimed at increasing reliance on market based mechanisms and competition to promote efficiency and competitiveness. Competitive neutrality requires that, where governments choose to provide services through market based mechanisms involving actual or potential competition from a private sector provider, the competition should be on equal terms.

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136 *The Doctrine of the Shield of the Crown,* December 1992.

137 Independent Committee of Inquiry, *National Competition Policy*, August 1993, (Hilmer report), p 293.

138 *Competition Principles Agreement*, April 1995, subclause 3(1).

The removal of governmental immunity for the Commonwealth, the States and the Territories would give investors (both in Australia and overseas) the confidence that the full requirements of the Law were applicable, consistent with the aim of encouraging increased public investment. The action of governments in a number of privatisations in seeking to have the Corporations Law apply to the prospectus in question indicates that this is the better course.

Accordingly, the Commonwealth, States and Territories should no longer be immune from the fundraising provisions.

Removal of the immunity of the States and the Northern Territory would require the agreement of the relevant Governments and Parliaments. Whether or not this agreement is obtained, the immunity of the Commonwealth should be removed.

The fundraising rules as currently drafted do not apply to government guaranteed debt issues, such as Commonwealth bonds, because the guaranteed return of capital and interest removes any risk involved for the investor. Given the absence of risk involved, the arguments about inappropriate advantage to government do not justify a legislative disclosure requirement and the current exemption should be retained.

Proposal No. 21 — Governmental Immunity

The Federal, State and Territory Governments and their business enterprises should be subject to the fundraising provisions except in relation to offers of government guaranteed debt securities.

APPENDIX A: BUSINESS REGULATION ADVISORY GROUP

Mrs Catherine Walter	(Chairman) Australian Institute of Company Directors
Mr Peter Barnett	Business Council of Australia
Mr Leigh Hall	Australian Investment Managers' Association
Mr Rohan Jeffs	Australian Chamber of Commerce and Industry
Mr Jeffrey Lucy	Accounting bodies
Mr John Murray	Small Business Coalition
Mr Robert Nottle	Australian Stock Exchange
Mr Malcolm Starr	Sydney Futures Exchange
Mr Les Taylor	Australian Corporate Lawyers Association

APPENDIX B: COMPETITIVE EQUITY MARKETS: ECONOMIC ANALYSIS

Capital Market Behaviour

The role of a capital market in raising funds through the issue of securities is to provide a link between business and investors. It provides signals allowing funds to be invested where there is the highest demand for end products and therefore the highest returns from investing. An efficient capital market will allocate capital to its most efficient application. It will promote economic growth and employment, and result in an economy which is more vigorous and responsive to both domestic and international changes.

In assessing the need for legislative intervention in the manner in which fundraising is conducted, it is necessary to consider how the market place can operate most efficiently.

Addressing Information Imbalances

The availability of reliable information is at the heart of an efficient capital market. The disclosure of sufficient reliable information enables market participants to make confident assessments about securities on offer. Confidence and stability in the market as a whole is achieved and maintained when participants know that issuers will make reliable and comprehensive disclosure. Potential investors value disclosure by issuers because that disclosure reduces the information imbalance between the issuer and the investors, and therefore reduces investors' search costs. It is the issuer who is best placed to describe the investment and disclosure to the market by the issuer will reduce the need for individual investors to undertake their own detailed searches.

Mandatory disclosure rules establish a threshold for the standard of information required to be disclosed to the market, so that investments which will provide the best combination of risk and potential return can be identified. The rules seek to remedy the investors' lack of information. However, there are compliance costs associated with the mandatory disclosure rules, including the costs of compiling and disseminating the information.

Costs are also potentially incurred by non-compliance with the disclosure rules. The rules therefore create a tension for the fundraiser between the likely profitability of the proposed use of the funds and the cost of complying with the disclosure obligation. If the compliance costs are too high, the fundraiser's proposed equity capital raising will become unattractive and it will not raise the funds by that method.

Mandatory disclosure and liability rules therefore have the potential to cause some fundraisers not to pursue potentially profitable investment opportunities. Others will finance these opportunities internally or from loans, rather than relying on fresh equity, even though this may reduce profits and put other pressures on the business through the imposition of loan servicing costs.

It follows that inappropriate mandatory disclosure and liability rules have the potential to distort the market by discouraging some businesses from undertaking equity fundraising when they would otherwise do so. The adoption of appropriate disclosure and liability rules is therefore crucial in establishing and maintaining an efficient market.

Market Information and Disclosure

The starting point for an analysis of fundraising regulation is that more informed decisions by investors will lead to more efficient investment outcomes. By participating in an investment opportunity, an investor assumes a certain amount of risk which they are willing to bear on the basis of likely returns. As risk is one of the major features of an investment opportunity, investment funds will be allocated more efficiently if investors are informed about the factors contributing to this risk, as well as about potential returns on the investment. A key policy objective is therefore to bring about an investment environment in which investors are properly informed about the risks associated with investment opportunities.

In the absence of mandatory disclosure, not all participants in the market will have the same information. In some cases the market may consider that fundraisers have information about the risks associated with a proposed investment that is not available to all potential investors. Potential investors would react to this by:

- altering the mix of investments in which they are willing to participate, resulting in sub-optimal investment decisions;

- expending resources that would otherwise be available for investment on seeking information considered necessary to making better investment decisions; or
- not investing at all.

Conversely, a downturn in available investment funds will mean, some fundraisers will not be able to pursue the opportunities which would have been available to them, had sufficient funds been raised.

Information imbalances will therefore result in inefficient allocations of resources for both fundraisers and potential investors.

Level of Disclosure

Fundraisers therefore have an incentive to make the disclosures required to persuade investors that they should invest in them. Fundraisers with *good news* have the most incentive to make disclosures, because this will encourage investment in them. Market participants will draw adverse inferences from non-disclosing fundraisers, encouraging the more attractive of the remaining fundraisers to make disclosures about themselves. Other fundraisers may ultimately have an incentive to disclose *bad news* in order to avoid an inference that their position is worse than is actually the case.

However, if the market is characterised by a high level of disclosure — and thus a high level of confidence — but disclosure is voluntary then a *free rider* problem is likely to arise as some fundraisers seek to take advantage of the overall high level of confidence in the market place by seeking funds without making adequate disclosure (particularly of bad news). The emergence of the free riders would affect investors' confidence in the market, leading to their withdrawal or sub-optimal investment decisions, because they could not discriminate between fully-disclosing and free-riding fundraisers. While it might be expected that the market would adjust in time, at least to some extent, so that those issuers making sufficient disclosure would attract investment and those making inadequate disclosure would not, this adjustment would occur at the cost of reducing overall confidence in the market.

Information disclosed to the market is supplied free of charge to other participants in the market. A fundraiser's competitors and others seeking fresh equity may benefit from the disclosure, but the fundraiser cannot charge them for their use of the information. Accordingly, some disclosures have the potential to damage the fundraiser's profitability. Examples of this type of information include advantages in technology held by it and information

about the market performance of the fundraiser (both of which may be of value to competitors).

In addition, fundraisers will be uncertain about whether they will be able to recoup from investors, in the form of higher prices for the securities on offer, the costs incurred in making all the disclosures likely to be of use to the investors. On the other hand, if search costs are borne by investors rather than the fundraiser, the overall costs will be greater (leaving less to invest) and smaller investors may be excluded from the market by the comparatively high cost of investing.

It is therefore likely that fundraisers will not voluntarily disclose some information known or available to them that investors would find useful in making their investment decisions, or will disclose information in a manner that would not facilitate comparisons between competing fundraisers. This is because, in a voluntary regime, issuers would have incentives to make less than full disclosure. Mandatory disclosure rules should therefore aim to elicit the right level of disclosure to sustain market confidence.

Small Business

Legislative intervention in equity capital raising is justified in order to ensure that an efficient and confident securities market based on reliable information exists. However, for some issuers, the transaction cost of preparing a prospectus will be high, relative to the amount of funds being raised. This will especially be the case for SMEs. These fundraisers may not proceed with the opportunities sought to be funded through the fresh equity, or may finance them internally or by loans.

Because of their low capital base, SMEs are less able to meet the costs of capital raising. Successful SMEs are vital to economic prosperity as they provide substantial employment and adapt quickly and efficiently to market changes and opportunities. In the interests of promoting economic growth and national wealth, employment growth and export earnings, it is important that impediments to the development of SMEs be identified and removed. This warrants adaptation of disclosure rules to reflect the lower starting base of small business.

Transaction and Search Costs

The search costs borne by investors will primarily relate to the need to collect and assess information about a particular offer of securities. Regulatory

intervention in the form of mandatory prospectus disclosures will, for most investors, reduce the search costs incurred in collecting information. The costs incurred in accessing the information will depend on the individual investor's ability to assess it. Information presented in a way which makes it easy to understand will therefore reduce investors' search costs. Other search costs will also be incurred, including the costs of understanding the rules (whether disclosure or other associated conduct rules, including the penalties for non-compliance), while further costs may be incurred in making comparisons between the merits of different investments.

While a high degree of uniformity, simplicity and consistency will promote efficiency in information preparation and distribution, some investments will ideally be subject to different rules depending on the needs of investors. For example, a sophisticated investor or large investor will not need the same disclosure as a retail investor because they are better placed to look after their own interests and deal with the fundraiser with an equality of bargaining power. It is therefore desirable that some exceptions to the general disclosure rule be provided and that the system have a degree of flexibility, as well as a capacity to change in light of changing market place conditions and the experience gained in its operation.

Advertising

The manner in which information is disseminated to the market and individual investors can also have an important impact on its efficiency. In particular, a wide dissemination of information in the form of advertising about an offer of securities is likely to attract investors who would not otherwise have known about the investment opportunity. This may lead to a higher level of investment at a lower overall cost. However, information contained in advertisements for marketing purposes should not be substituted for proper disclosure. Restrictions on conduct which is inconsistent with informed decision-making, for example advertising which encourages investment decisions on the basis of the advertisement rather than on prospectus disclosures, are likely to contribute to an efficient market, providing they do not inhibit the free flow of material information to investors.

Liability

The need to maintain a properly informed securities market justifies the imposition of mandatory disclosure rules. In the mandatory disclosure context,

consideration needs to be given to the consequences of non-compliance with those rules.

From an investor's perspective, the liability rules for fraudulent or inadequate disclosure (whether criminal, civil or both) will be an important part of the investment decision. The higher the potential liability, the more likely it is that potential investors will have confidence in the quality of the information that is being provided. Conversely, the lower the liability, the less likely it is that investors will have confidence in the information and in their prospects of being compensated in respect of inadequate disclosure. This level of confidence is likely to affect the level of investment, both in particular securities and in the market as a whole. The overall level of fundraising will be higher if investors are confident that the rules provide sufficient incentives for full disclosure. This consideration must be balanced against the crucial issue of the cost of imposing liability.

For some fundraisers a requirement to disclose all information which is material to an investment decision will involve a search for information not currently known to them. Fundraisers will continue to search for new information so long as the cost of searching is less than the cost of the risk that disclosure will subsequently be found to have been inadequate. Any potential liability for non-disclosure will therefore play a major role in determining the extent to which fundraisers search for new information. The higher the potential liability, the greater the incentive to incur costs by searching further. For some fundraisers, the liability rules would operate as a disincentive to seek fresh equity, because the search cost would be too high.

The transaction costs involved in the operation of the liability system, which will be borne by both investors and fundraisers to differing extents, also need to be taken into account. Some of these costs will be borne by the market as a whole or the taxpayer, including much of the cost of the regulator and of the dispute resolution system.

Competitive Neutrality

In a truly competitive market, all participants who are selling equivalent products should be subject to equivalent regulation. As the Commonwealth, the States and Territories are not subject to the operation of the Corporations Law in their fundraising activities, this is not currently occurring.

Policy Framework for Fundraising Regulation

The above analysis suggests that legislative intervention is justified to provide a disclosure and liability regime designed to ensure fundraisers disclose information about the potential returns and risks associated with investing in them, with a view to removing information imbalances. The aim of this intervention is to achieve an appropriate balance between the costs and benefits involved in the regulatory regime. The benefits of maintaining an efficient capital market and investor confidence in that market must be balanced against the costs to the fundraisers of complying with that regime. In particular, the disclosure and liability rules should include the following features:

- the disclosure rules should require that the market be provided with the information needed for informed decision making;
- the disclosure rules should be cost effective, so that the cost to issuers of complying with them does not exceed the benefits to investors of that compliance;
- information should be provided in a single document or by reference to a single document so that investors' search costs are minimised;
- the same disclosure and liability rules should apply, in general, to different investments so as to facilitate comparisons between different investments and enhance competition in the market place. Similarly, in making investment decisions, reliance on the information required to be disclosed, rather than that contained in voluntary advertisements, should be encouraged;
- exemptions or reduced disclosure rules may be justified where:
  - the cost of making the disclosure would be disproportionate to the amount being raised, for example, where the total amount being raised is small; or
  - investors are sufficiently sophisticated to decide for themselves whether to invest on the available information or to seek further information;
- investors should be given a reasonable degree of confidence in the quality of the information provided and in the conduct of fundraisers so as to reduce their transaction and search costs in individually assessing this information and conduct;

- to achieve this confidence, fundraisers should have an incentive to provide the best possible information through imposing liability for non-compliance with the rules. The liability rules should provide an efficient system for compensating investors. However, given the inherent uncertainty and risks involved with business ventures, fundraisers should be able to take steps which give them reasonable confidence about the extent of their potential liability;
- the regulator should leave responsibility for compliance as far as possible with fundraisers, but should be able to take remedial action and to modify the operation of the rules in light of market failures; and
- the principles of competitive neutrality should apply.