

THE CASE FOR AND AGAINST ESTABLISHMENT OF
A SECURITIES AND EXCHANGE COMMISSION IN AUSTRALIA

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Lest the arguments discussed in this paper have less force by being hypothetical, it is wise to define the assumptions made, at the gain of clarity but for the loss of a certain degree of usefulness.

Firstly, the question does not call for the writer's opinion on the strength of opposing views, so these are not given.

Secondly, the subject matter is defined as Federal control, and therefore, for example, control by co-ordination by the States is ruled out.

Thirdly, the Federal body proposed is assumed to be an authority superimposed upon the existing regulatory structure, and not in replacement of any present element of regulation. If this assumption is not made the discussion would need to range far beyond the limits set to be of any value.

Further, it is taken that in general the proposal is evaluated against the present scene (which it is assumed needs further control) and that the options are either further control by the proposed Federal body or by any one or more of all the possible alternatives. This is the main issue in this paper.

The proposed body is taken to be one along the lines of the United States' Securities & Exchange Commission (the SEC) and though this lacks some precision, the body is assumed to be one closely modelled on the SEC, and not a modified version of it such as Canada has in the Ontario Securities Commission.

Finally, it has been assumed that the Commonwealth Government has constitutional power under Section 51 (xx) to enact the legislation setting up the Federal body. The position now is clearer since the date of the High Court's dicta in the trade practices judgment and the 'Concrete Pipes' case. Indeed, the Senate Select Committee on Securities and Exchange (the SSC), has assumed that the Commonwealth has this power in preparing its report and recommendations on its terms of reference, which are inter alia 'to inquire into and report upon the desirability and feasibility of establishing a securities and exchange commission by the Commonwealth ---.'

The purpose of supervision and control, whether by statute law or by regulation under the law, is to re-inforce the remedies available under the common law to an individual who has suffered loss or damage. An important difference is that under the common law the cost of recovery must be borne by the individual, who wastes further losses if he is unable to furnish sufficient evidence to win, while under the statute law, society at large bears the cost.

Therefore the important considerations are the extent to which society is prepared to accept responsibility for control and regulation by legislation, supervision, investigation and enforcement through the courts, and in what manner, and at what minimum cost, these responsibilities can be adequately

discharged. Society is prepared to accept a certain amount of responsibility because each individual regards this as a form of insurance against his suffering greater personal loss from being accidentally involved in the future, and because the cost is painlessly hidden in conglomerate claims in taxes and duties which pay for the many benefits he enjoys.

The benefits of accepting more and more social responsibility should be related to the cost and the method of regulation chosen should minimise that cost. Difficult as it usually is to quantify these factors, these are the criteria against which any measures should be principally evaluated.

The SEC is responsible under the 1933 Securities Act for the acceptance for registration of very comprehensive statements in relation to new issues of securities supported by prospectuses issued to the public. The 1934 Securities Exchange Act authorises the SEC to supervise the stock exchanges, enforce registration of all listed securities, accept filing of current financial information about the relevant companies, regulate proxy distribution and control insider trading, short selling, fictitious sales and so on. Quasi-judicial proceedings involving the Commission may be instigated by the SEC, and as 'amicus curiae' in private suits.

An important role of the SEC is to make rules and carry out investigations. The rules have included accounting rules, but the scope of this power has been widened to include rules which prescribe methods of business and the most minute specification of the format in which information is to be presented. Information obtained during its detailed investigations can be published as an aid to protection. Investigations are held also to aid the enforcement of its rules and to obtain further information, to be used as a basis for legislative reform.

The scope of the work of the SEC is accordingly much larger than is carried out by the State Corporate Affairs Commissions (the CACs), and manpower requirements and costs are enormous, and well above the present levels in Australia after adjusting for the different populations levels. To carry out similar regulatory duties the Federal body would need adequate staffs and the necessary budget allocation. The cost of this would be over and above the costs of the State CACs. It is another question whether the skilled staff can be drawn together to accomplish the tasks which would be given it to do, specially in relation to assessing whether action should or should not be commenced in any given case.

The amount of extra work which would be thrown onto company staffs is also worth noting.

Even under the present system it is sometimes pointed out that low budget allocations prevent the authorities from fulfilling their roles effectively. In an attempt to overcome this difficulty, they force industry to supply more and more information. Not only is this a cost but it may mean the distraction of skilled executives in industry towards form-filling. The SEC's annual budget of \$24,730,000 may be compared with the NSW CAC's investigating staff of only forty-three people, the largest in Australia.

It seems reasonable to infer that a very great increase in total costs would be implied by an SEC-type body in Australia.

The great volume of detail does not necessarily imply accuracy, meaning or security; indeed it may give a feeling of false security. The SEC will supply experts to help a company in reviewing statements it has filed, so that the public may accept uncritically reports issued by companies on the assumption that the SEC imprimatur guarantees reliability. The

SEC is conscious of the dangers of too much detail. The SEC has not eliminated frauds and manipulations in spite of the enormous quantity of detail published.

This detail nevertheless may be of value to the government both in its use to guide future legislative action and in general economic planning. It is quite likely that once a regulatory body was established it would tend to call for greater budget allocations to meet rising costs, as this was the SEC pattern. To restrict the body's income would defeat its objectives and make it into a paper tiger.

One of the duties of the SEC is to standardise the principles upon which accounting information is supplied. This approach has its supporters although they may acknowledge that the SEC has been over-zealous. The object is to make intricate financial statements intelligible to the investor, but this may be an impossible task, and one better left to the skilled specialist. Unfortunately, it leads to the imposition of authoritarian views and procedures in an area of accounting theory where even specialists realise that much more research and exploration of new ideas is needed before a satisfactory solution to the present conflict is found.

Some favour uniformity (though not necessarily of the SEC type criticised by Chambers so strongly), and others feel that several approaches may be preferred provided the bases adopted are explained in detail to the reader. Certainly the latter needs very much more responsible reporting than is the present practice, under which some degree of uniformity is the only way of preventing a chaotic situation. In the States, the SEC's regulations have forced companies to report financial statements in a form which the Federal Trade Commission in 1969 said 'may conceal as much as it reveals of a company's true economic condition.'

Rather than abrogate their functions to the lawyers, the accountants have suggested the establishment of their own court of reference in place of the straightjacket of the SEC's regulations.

The law does lay down some simple principles in the format of reporting, and it is likely that an SEC-type body would impose a far greater degree of uniformity in the format of financial reports and the principles under which they are derived, as has the SEC in the States.

The incursion by an 'SEC' into the domain of the professional practitioner can be compared with the moral right of such a body to decide what is in the interests of the investor - whatever that term embraces. The cost discussed above is one matter. For example, one writer asserts that to raise \$250,000 equity capital in the U.S., costs related to satisfying SEC requirements of roughly \$100,000 will be incurred. Another matter is the right of a non-judicial body to possibly prejudice the interests of one group in order to protect what it considers in danger through a course of action being taken by directors, management or others.

In satisfying the complicated requirements of the SEC flexibility which may be to the shareholders' advantage may be lost. Some prefer the alternative remedy, the more thorough inquiry which would follow the bringing of a civil suit after the event by a party who had suffered damages or the preferring of criminal charges by the Crown. The possibility of these is a deterrent, while the existence of preventive machinery may still be insufficient to eliminate improper practices by those who wish to indulge and who can carefully analyse the SEC's requirements and so steer a course through the visible hazards. The situation is similar to the choice of concealing a policeman

in a side-street or have him drive prominently in the middle of the traffic.

The Commissioner for Corporate Affairs in N.S.W. believes that there are adequate measures available under existing legislation; the Companies Act, the Crimes Act and powers of investigation under the latter, and that SEC-type measures imply an intrusion into the affairs of operating public companies.

On the other hand, it is necessary to have some way of looking after the interests of the small investor who as an individual may not have the resources to bring an action himself. However it is hard to imagine many cases where a course of action is going to injure minority shareholders without also injuring the major shareholders (who would deem it worthwhile to bring an action) except where it is a re-arrangement of the interests of the shareholders inter-se. For example, the articles may be amended to change the sliding-scale voting rights. In such a case the Stock Exchange could be induced to act if the interests of a minority were to be seriously affected.

Contrary to the criticism that the SEC is too unwieldy, discussed above, some argue that it is more flexible and speedy than judicial controls, and would act when the Stock Exchange body, inhibited by fear of being considered impetuous and vulnerable to damages suits would not do so. However the government can also act speedily in appropriate circumstances; for example, in the bringing in of provisions covering borrowing Corporations following the spectacular company failures of the early 1960s in Australia.

The Chairman of the SSC has emphasised the importance of a speedy response by the regulatory body to new situations and demands. Certainly it is likely that the response can indeed be speedier than the effect of new legislation, but it tends to be more arbitrary and does not have the merit of being subjected to as much critical analysis. A system whereby a body advises the government which in turn controls by legislation combines the advantages of both. It is already in existence in the form of the CACs and such bodies as the Company Law Advisory Committee (the Eggleston Committee) the Senate Select Committee on Foreign Ownership, and the Committee on Foreign Takeovers. The speed with which the last was formed, and the associated legislation enacted, was a model in flexibility. It also showed that the existing machinery could be considered to be sufficiently effective.

Although both the Chairman of the SSC (quoted above) and the Chairman of the Sydney Stock Exchange welcome a flexible agency, neither reveal whether in his opinion the SEC has this quality, though they both are in favour of some kind of Federal agency. The Chairman of the Sydney Stock Exchange asserts that the Australian Associated Stock Exchanges (the AASE) must be consulted in the setting up of the body so that legitimate enterprise will not be inhibited.

It is true that public confidence in the securities industry is consistent with a reasonable amount of freedom for the exercise of initiative and entrepreneurship, but public opinion has tended to be a little cynical about the effectiveness of control by the AASE when incidents such as the Glomex, Nickelfields and Queensland Mines affairs are recalled. In principle the concept of self-regulation is difficult to accept because of the apparent conflict of interest and the competition within the 'club' by its members for business. Opinion seems to come down strongly against the effectiveness of self-control by the AASE, on the regulation of both the activities of companies and the members themselves, without a two-tier structure of internal

control under overall Federal supervision.

The AASE have in the last two years moved rapidly to improve the in-house control of their affairs, by appointing an independent Chairman from overseas (February 1972). He will guide the AASE towards forming a national exchange, a move recommended by the Senate Select Committee on Foreign Ownership. Also they have raised the minimum issued capital of an applicant company from \$200,000 to possibly \$750,000 and have eliminated single-member firms. The Perth exchange has introduced several further measures. But these moves do little to deal with the problem. There are a few inherent and unavoidable weaknesses.

Firstly, the income of brokers depends upon turnovers, and by refusing to list or by de-listing securities the Exchange cuts out a potential source of income for its members. Secondly, there are few remedies available, the main one being to de-list a security, which could harm innocent shareholders of the stock. After all, an exchange's first duty is to maintain a market. Another proposed remedy is to refuse to list any future issues by the company concerned or of companies connected with the directors involved.

Since the securities industry works against a general background of commerce and industry which have features peculiar to the various States, it is likely that the State exchanges will have some differences of opinion on the scope and speed with which reforms should be implemented. For example the Perth Exchange with few members, and small turnovers but with a strong mining industry in its State has been pushing for wider reforms than the Sydney and Melbourne exchanges believe are desirable.

There is concern that the exchanges will not necessarily act effectively owing to reluctance to be exposed to litigation, in a situation where they are not financially very strong. In a sense and quite rightly, a broker may wonder why at some cost he must assume a responsibility which should be borne by the public. In particular, the General Manager of the Sydney Stock Exchange remarked that it was up to the mining industry to control its standards. This occurred in the same month that Senator Rae hinted that the Federal Government might have to impose standards. Even if the AASE performed well indeed, the public may not recognise this to be the case owing to a 'credibility gap' caused by the 'in-house' nature of the controlling committee. In any case it is unlikely that the public would accept government by any private body. Although the AASE (formed in 1957) standardised almost completely the listing requirements, each exchange has its own rules which are not uniform. In addition, the information published about companies by the various exchanges has been the result of separate research activities and has not been uniform.

These reasons do support the argument that it is unreasonable to expect the AASE to effectively control the activities of listed companies, let alone the securities industry as a whole. On the other hand, as an alternative to Federal control, they could effectively initiate the formation of a combined committee representing the accountancy, legal, sharebroking and banking professions which would define ethical standards. Again, in an attempt to forestall Federal encroachment on present State territory, the N.S.W. Attorney General formed in February, 1972 a Corporate Affairs Advisory Committee representing brokers, directors, accountants and lawyers. Whether this would work as well as the City of London Takeover Panel depends upon how different from England are the conditions and standards in Australia. One important factor is that our need for a steady inflow of new capital demands a slightly more relaxed atmosphere for the exercise of initiative.

The SEC performs some of the watchdog functions which have been discussed in the context of control by the AASE. Being a Federal body it can over-ride State boundaries, which is a limitation inherent in Australian State control. Secondly, it is staffed with expert geologists, economists, statisticians and engineers who can give their attention to evaluating the information furnished by companies. It is unlikely that there is the conflict in these sciences that exist between the SEC's principles and the accounting profession in accounting theory discussed earlier. These experts play a valuable part in control and regulation, for as Senator Rae stated in the Senate, a Federal regulatory body must have 'the power to investigate nationally and follow-up effectively'. This implies the use of technical experts to evaluate technical reports. Another advantage of this approach is that prospectuses containing technical reports can be independently 'cleared' by SEC experts before issue. Possible 'post mortems' about technical opinions can thus be avoided.

Related to the concept of a national exchange is the growing internationalism of commerce and the growth of foreign investment. It is likely that stronger controls on the securities industry will encourage investment by overseas companies which, owing to their typical large size usually plan to operate in all States, as merchant bankers, financiers and so on. They would be expected to welcome increased supervision by an SEC-type body, which would encourage the development of Australia as one of the main financial centres of the Pacific. On the other hand, control by the States independently would probably deter foreign investment to some extent as there is the uncertainty and the possibility of action by any one of seven governments.

Interference by the Victorian government in the TNT/Ansett affair illustrates the dangers of the effect of parochial interests. This has had something to do with the drift of State Companies legislation away from the ideal of uniformity in the 1961 Act. Further, the initial adoption of uniform provisions is likely to be an aggregation of the legal, lowest common denominator. In other words, contentious legislation will tend to be modified so as to achieve agreement by all parties. Then, by amendment and tightening of the law, States will be tempted to show that they are out-smarting each other. This can only lead to the dismay of overseas investors, who are starting to recover from the debacle of the 1970 mining market. Again, non-uniform State Acts make the job of maintaining uniform amending Acts a highly complex task. It took two years for NSW to pass the latest amending Act. Transfer of the Matrimonial Causes and Bankruptcy jurisdictions to the Commonwealth has been generally welcomed, and it is likely that Companies legislation similarly would be an improvement over the present system and may be preferable to an SEC-type body.

The work of the SEC in the States has been touched on in the above discussion. It is only possible (and really helpful) to look briefly at the framework of and the work done by the United States body.

It was introduced at a time when the United States had suffered its worst depression. Malpractices in securities were thriving with little or no control being exercised by the various stock exchanges. Worthless stock was being floated with regular monotony; manipulation of stock prices was rampant; information was used by company managers to their own advantage; current reports filed by companies were not subject to anything like the control necessary to ensure meaningful information to investors. And amidst all of this there was a vital election campaign for

the U.S. Presidency. Roosevelt campaigned on a platform which included as one of his promises the establishment of a commission and there is little doubt that this played a significant part in his success.

The most important Acts in relation to the work done by the Commission, are the Securities Act of 1933 and the Securities Exchange Act of 1934. Under the former Congress aimed at controlling the initial distribution of securities which are offered to the public either through the mails or through the channels of interstate commerce; all of these (subject to certain exemptions) are required to be registered with the Commission. The registration statement is a very comprehensive document. Civil and criminal liabilities are imposed for material misstatements or omissions.

The 1934 Act is concerned with post-distribution trading in the relevant securities. Loss describes this legislation as having four purposes: "to afford a measure of disclosure to people who buy and sell securities; to prevent and afford remedies for fraud in securities trading and manipulation of the market; to regulate the securities markets; and to control the amount of the Nation's credit which goes into those markets."

All stock exchanges are required to register with the Commission which has certain important supervisory roles to play. No securities may be listed without registration of same both with the appropriate exchange and the SEC, information about the relevant company must be current (i.e. accounts, etc.). The Act also regulates proxy solicitation and distribution, and the Act controls insider trading.

Quasi-judicial proceedings involving the Commission may be instigated either by the Commission or by persons under jurisdiction of this body. Of course orders which flow from such hearings are open to review.

A role which has been consistently played by the Commission in judicial proceedings is as 'amicus curiae' in private actions involving provisions of the various Acts.

But the most important role played is that of rule making and investigation. The Commission has power to make rules to facilitate its statutory function. In particular the Commission has evolved accounting rules and matters related to the maintenance of meaningful and up to date information about securities traded. But the scope of its rule making power is indeed varied and is not limited to the field mentioned.

Having noted the SEC's main functions, and although some of the matters have been introduced in discussing the roles of the various existing Australian bodies, it would be useful to consider a few of the main areas in which control would be most profitable and how it could be best used. These are the issue of prospectuses, proxy contents, accounts and audit, insider trading and stock exchange control.

In Australia, every prospectus has to be registered with the CCA, who will assess it so as to form an opinion as to whether "the prospectus does not contain any statement or matter which is misleading in the form or context in which it is included." In practice the CCA merely sees that the prospectus 'appears' to comply with the Act. Contrast this with the rigorous analysis carried out by SEC experts in the States. Obviously the legal provisions could be tightened up, and the CCA's staff expanded to cater for a careful review of each document lodged. The objective of control should be to provide meaningful information rather than quantities of simple statements.

Another important area of control is in proxy contents. Neither the Companies Act nor the AASE Rules cover this matter adequately,

and often the information given out is dressed up to suit the tactics. The SEC has the power to assume the basic honesty and integrity of the market. The SEC regulations ensure adequate disclosure, and that body will go to litigation if any copies of solicitations or circulars (all of which have to be filed) contain false or misleading information. Under the Companies Acts, all shareholders are entitled to proxies. But a group challenging management for control has to use its own funds, while the management can use the company's funds to distribute, unchallenged, circulars, to inform the shareholders of the policy of the company.' Again, the law can be tightened, but this is useless unless the people are there to review the material filed. The AASE require that companies lodge copies of all circulars, but, again, there is no one to review them for their content.

The matter of accounts and audit has been fully covered above, and the problems of enforcing uniformity noted. The Australian law and AASE requirements only touch on the problem of accounting practice, leaving an enormously dangerous void, not necessarily best dealt with the SEC way.

Section 124(2) of the Companies Act can be compared with the U.S. Securities Exchange Act 1934 S16(a) and (b) and Rule 10b-5 dealing with insider trading. The Australian provisions fall very far short of the SEC's powers specially in relation to the Rule 10b-5, and the Jenkins Committee has recommended similar provisions to those. This is one case where an SEC form of control is probably very worthwhile because costs of litigation are high and directors are easily able to conceal their indiscretions.

The question of control by and of the Stock Exchange has been dealt with earlier. It seems that the AASE are making very positive moves to avoid outside regulation, but that such action is not likely to be sufficient to satisfy the SSC.

It is necessary to bring these two separate discussions together in a sense by mentioning the philosophy of regulation. Recall that the first considered some of the institutions, and the second some of the matters wherein regulation would seem to be worthwhile.

Loss states that the British philosophy is one of disclosure. It is a criminal offence to fail to give a prospectus to a person who is asked to take up an issue, and a director can be sued for the tort of misstatement in a prospectus. For a government to do more 'would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State.' However the States, recognising that all individuals are not endowed with equal wisdom, legislated on the premise of three principles, to deter fraud by investigation and punishment, to register or licence operators and to register the securities themselves. When Congress legislated in 1933 it combined the regulatory philosophy of the States with the disclosure philosophy of Great Britain. Thus the SEC exercises all three governmental functions - legislative, judicial and executive.

This paper attempted to bring forward some of the most important issues which must be recognised. An opinion on the best course will rest largely on value judgments upon those issues. Of these value judgments none is probably more important than the question of whether a body which has broad discretionary powers, which can be exercised ex-ante and which must have to evaluate what the interests of some nebulous group or groups are, is better than another body which punishes ex-post. Such, somewhat simplified, is the nature of the choice between an SEC and the Courts of Law.