"TOWARDS AN EFFICIENT, COMPETITIVE AND INFORMED MARKET" SECURITIES INSTITUTE OF AUSTRALIA

An Address by
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From time to time I have said that one of the key factors to the success of the NCSC will be the promotion and maintenance of a competitive and efficient, and informed stock market. As those words have now been written into the legislation known as the Companies (Acquisition of Shares) Act 1980, I thought that it would be a useful exercise if I were to formulate the Commission's perception of those words.

Section 59 of the Companies (Acquisition of Shares) Act provides that in exercising any of its powers under Section 57 or 58 (i.e. the power of exemption and the power to declare that the Act applies as if modified) the Commission is obliged to take account of the desirability of ensuring that the acquisitions of shares in companies takes place in an efficient, competitive and informed market and without limiting the generality of the foregoing, the Commission needs to ensure:

(a) That the shareholders and the directors of the company, know the identity of any person who proposes to acquire a substantial interest in the company;

(b) That the shareholders and directors of the company have a reasonable time in which to consider any proposal under which a person would acquire a substantial interest in that company;

(c) That the shareholders and directors of the company are supplied with sufficient information to enable them to assess the merits of any proposal under which a person would acquire a substantial interest in a company;

(d) That as far as practicable, all the shareholders of the company have equal opportunity to participate in any benefits accruing to shareholders under any proposal whereby the bidder would acquire a substantial interest in the company.

Any stock market should be viewed from two aspects:

(a) As a place where transactions in securities are carried out; and

(b) A place where prices are set and where capital is generated for new or established companies that wish to expand.

It is generally agreed that in any free enterprise system the securities markets perform essential and important functions. These functions are inter-related and are therefore difficult to separate neatly, but it could be said:

1. A securities market provides liquidity;
2. A securities market (certainly an efficient one) provides a continuous setting of a price for securities and in particular equity or ordinary shares.

Each of those two propositions require some amplification.

When we say that the market provides liquidity, we imply that, in an efficient secondary market, permanent or long-term investment in corporate assets does not have to be financed by equally permanent or long-term commitment of funds by any one investor. In an efficient secondary market, the funding can be permanent for investors as a group as it can be permanent or temporary for any individual or institutional investor.

The term 'liquidity' has many dimensions, but we usually mean by that expression the ease and speed at which interests can be transferred. Investors look to efficiency in the securities industry in two senses:

(a) The efficiency of those who are engaged in the industry, that is to say, brokers.

(b) The efficiency of the market place, i.e. how quickly the market responds to new information.

I will deal with each of these matters briefly. The main ingredients of the efficiency of those who are engaged in the industry are:

First, the clearing and settling of transactions that have been executed; and secondly, the reporting by brokers to buyers and sellers. Both are worthy of some attention.

The present system for transferring ownership from seller to buyers is essentially a physical one. Securities are delivered by sellers to brokers, are registered in the appropriate company, and are then physically delivered by the company to the buyer.

Expeditious and accurate reporting by brokers to both buyers and sellers that a transaction has been completed on their behalf, is an essential requisite of an efficient market place.

Historically, each broking firm, no matter how large or small it is, has run and managed its own 'back office' as the scrip department and the accounting and reporting department are called. It is a well-known fact, however, that in a boom market great stresses are placed upon the back rooms, and in the past we have ample evidence both in Australia and in other parts of the world of failures in the back office, which in some cases have affected the very survival of the firm itself.

There is available a considerable amount of well documented evidence of the sorts of problems which may be encountered from time to time in a broker's office. When back office employees tried to alert the senior partners of firms comprising the New York Stock Exchange to the growing paper problems during the late 1960's, the reactions were usually a bored shrug. Volume was booming, commissions were rolling in, so how could anything serious be wrong? It was some time before the New York Stock Exchange became concerned and then only when the press began to report the paperwork crunch.

Those who require evidence of the difficulties which the paperwork crunch occasioned, should read the case histories of two New York firms, namely McDonnell & Co., and Dempsey-Tegler – large firms which had at one time over 750,000 customer accounts and over $50 million in capitial resources.

In an electronic age one thinks in terms of a nation-wide communications network. The two principal advantages of a nation-wide communciations network perceived in terms of an efficient securities market are:

(a) A means of tying together all market participants on a truly national basis for the purpose of exchanging information on all bids and offers to buy and sell any security covered by the system; and

(b) A method of instantaneously reporting all transactions in any of the relevant securities.

Ideally every broker would have access to a nation-wide communication system which would bring together and display in one location, such as a desk-type television screen, all bids and offers currently available in any market centre. Likewise every completed transaction no matter where it occurred would be reported through this national network. Computer accounting technology at this point of time is expensive, but clearly the trend is in that direction and we will probably see in the next decade the development of a national market in operation with rationalised back office operations.

In December 1973, the Australian Association of Stock Exchanges determined that a computerised integrated market for all listed securities in Australia was not at the point of time commercially feasible and could not be justified given the volume of trading, the number of shareholders, the market capitalisation and the total number of company securities.

In 1976 Sydney and Melbourne Exchanges adopted a joint floor arrangement and established a joint computer operation. Under the joint floor arrangement brokers of the Sydney or Melbourne Exchanges are able to directly buy or sell on the floor of the market. Currently about eight large Sydney-based broking firms have representatives in Melbourne and three Melbourne firms have representatives in Sydney. Recently a Trans-lux visible ticker tape was introduced in Sydney and Melbourne displaying the latest sale price in approximately 300 most frequently traded stocks in the two cities. This is displayed within seconds of the transactions followed in minutes by details of the number of shares traded. In addition the main elements of any announcement by a company made on the floor of the Exchange are telexed immediately to all other Stock Exchanges. Whilst the Stock Exchanges have clearly moved towards consolidation, they would probably concede that they are still well short of providing a truly national market.

The other dimension of liquidity is the price at which investors can liquidate their holdings. This involves the continuous setting of a price for equity shares. There are many reasons why price and price behaviour are important. These include the willingness of investors to buy and hold equity securities, the cost of equity capital to companies, and a perception of the Stock Exchange as a major channel through which funds from savers and investors flow. I turn to the second dimension of efficiency, that is to say, how quickly the market responds to new information.

For those concerned with public policy, a critical question is 'how well are the markets working?' Economists usually answer in the form of an assessment of 'efficiency', but there are many kinds of efficiency as the term is applied to capital markets.

Some are relevant to the question of public policy and some are not. Often persons refer to aspects of efficiency but not of a kind particularly relevant to any public policy issue. The expression 'efficient market' as contained in the Companies (Acquisition of Shares) Act might be used in at least three senses:

- allocational efficiency,
- operational efficiency; and
- external efficiency

But one form of efficiency, namely, allocational efficiency, demands both external efficiency and operational efficiency.

When we talk of allocation efficiency of a market, we are referring to a market in which individuals, businesses and governments raise funds to invest in real assets like houses, machinery and roads.

That aspect of efficiency to which we address ourselves primarily is the pricing function of the secondary markets. The price of a company's share listed on the Sydney Stock Exchange reflects what investors expect from their investment in a stock, that is to say, the company's earnings, dividends and possible capital gains from the investment. The rate of return expected will depend on the risk or uncertainty that investors perceive in the share and it is this rate that constitutes the cost of equity capital to the company. This rate cannot be observed directly, but it can be deduced approximately from the quoted share price. The cost of equity capital is important because it serves as a criterion for investment decisions by the company itself. So long as a company is able to find investments in real assets that offer a rate of return above that cost, it will issue more shares and invest the proceeds. Investments made by a company will – or at least should – only be made if the anticipated return is greater that the cost of the funds invested. If the market is allocationally efficient then those prices, together with the company's expected earnings, are a good guide to each company's cost of capital. The company will need to take into account the return it will require from its investments if it is to service shares at their current price. Failure to achieve this return will lead to a fall in share price making it more difficult to raise funds and conversely, it is in this way that companies are induced into making an efficient choice of investments in real, productive assets.

Operational efficiency is measured by a market which has low transactional costs. A market is said to be operationally efficient if it is a market in which investors can easily transfer their investments from one user of capital to another or the selling of shares in one company and buying the shares in another. Operational efficiency is something thought of as being limited to broker's commissions but transactional costs also include the costs of obtaining information about investment opportunities and pricing this information.

External efficiency has to do with the relationship of information and prices – whether the market is 'fair game' for investors. A substantial amount of research has been done in both Australia and abroad on the efficiency of capital and securities markets in the external sense, but in an address such as this, it would be impossible to do such studies justice. Whilst generalisations are dangerous, empirical research which has been conducted into the behaviour of security prices in both the Australian and overseas capital markets relates to both the type of information which is received by the market and the speed of response of the market to such information. A market in this sense is said to be a fully efficient market in that there is no opportunity for an investor to make abnormal returns from the information he receives, since the effect of the information is already reflected in the share market price.

There are some sections of the market which are perceived as being in conventional terms externally inefficient. Investors in some mining and oil stocks probably realise that their purchase is a risk in that there is no guarantee of a return. They rely on the chance of extraordinary profits which might be realised by a small group of companies which do not constitute the average. This of course is one of the properties of any risk/return relationship and it is most clearly demonstrated with mining stocks. High risk is associated with high return, but the very nature of the risk can mean that the anticipated return is not realised. Investors probably regard some mining and oil stocks as equivalent to lottery tickets. Investors apparently regard mining and oil share purchases as a form of gambling and they tend to be poorly informed and overly optimistic.

I move on to the concept of a competitive market. One of the benefits of any competitive enterprise is the diffusion of power to many producers and consumers. It also has an analogy in the securities market. If there is diffusion of power amongst sellers and buyers, buyers will compete amongst themselves to pay the highest price, whereas if they were to act in concert they would want to pay the seller the lowest price. Sellers will compete amongst themselves to supply the lowest price, whereas acting in concert they would want to sell at the highest price. Competition has been regarded as a paradox whereby suppliers set out with the intention of maximising their profits and end up by minimising them. Conflicts become resolved by the establishment of a market place. Changes in the perceptions of opportunity cause changes in demand or supply and the eventual establishment of another price. The role of information and knowledge in competitive theory must be viewed against a background of the existence of proprietary rights over much of the information which is necessary for an objective perception and evaluation of market opportunities.

For example, confidential information in many instances can be claimed as being business property of a corporation and the personal use of such information may, therefore, be considered a misappropriation of a corporate asset. A case which rapidly comes to mind is the case of a misappropriation of a corporate secret or theft of customers' lists for use in a competing business. There is also information which belongs to the corporation which is price sensitive, in the sense that the use of such information on a selective basis will create the possibility for fortuitous profits and losses in the trading of securities. For this reason the law has now prohibited insider trading in order to maintain confidence in the integrity of the market, that is to say, in the accuracy of market prices. Senior management has an important role to play in this area. By making early public announcements concerning proprietary, data information by definition ceases to be price sensitive. Officers of a corporation are, therefore, deprived of opportunities of making trading profits and the flow of price relevant information from companies to the market is expedited.

As information has such a signifigant impact on price behaviour, it is of course essential for the market to be timely informed. It is now respectable economic theory that what is being bought or sold on the stock market is not only the underlying investment about which all information is known, but that an exchange of shares will often take place based on differing expectations about the future prospects of a given company. This may include expectations associated with a potential change in the control of that company. There are special situations where in order to maintain confidence in the integrity of the market, it is essential that certain information be reported.

I would like to make particular reference to the practice of 'warehousing' which could be defined as a situation in which a number of parties act in undisclosed concert that is to say, in a clandestine fashion, each acquiring an interest in the equity of the company and thus enabling one or more of them to acquire by stealth a dominant position in that company. We are not concerned in this context with insider trading, but rather with the need for 'insider reporting'.

It was the American specialist lawyer, Professor H. G. Manne, who renamed the stock market as 'the market for capital control'. His thesis is that the inherent danger of a takeover now plays the same role for managerial controlled companies that competition in the product market traditionally plays for the entrepreneur – i.e. a spur to efficiency and profitability. The stock market, according to this theory, is seen as the prophylactic against poor and inefficient management. The theory proceeds on the basis that apart from the stock market, we have no objective standard of managerial efficiency. Only the takeover mechanism provides some assurance of competitive protection to the interests of vast numbers of small non-controlled shareholders. Thus corporate control like any asset in an open market tends to move into the hands of those who can most profit from ownership. To achieve a more efficient market, an adequate flow of accurate information is necessary to enable existing owners and potential purchasers to assess the value of the shares in any given corporation.

Manne's theory could be regarded as a by-product of the theories of Adam Smith – perhaps most remembered as being the first British economist and the most famous advocate for private enterprise and free competition. He was also a stern critic of inefficient management. The interests of shareholders, according to Manne, are much more efficiently protected by market forces than by millions of small and unsophisticated shareholders trying to understand the subtleties and complexities of financial reporting. It was part of Manne's theory that the disclosure laws (certainly in the United States) merely served to raise costs for those outsiders who would otherwise compete for control of the corporations. In other words, he argued that the disclosure laws were seen to provide an additional cost buffer and were, therefore, protection for inefficient management.

I have endeavoured to explain the economic theories of the relationship between corporate control and the market place. How is this relevant to Australia?

In the second reading speech on the company takeovers bill, the then Minister for Business and Consumer Affairs, Mr Wal Fife made the following general comments on the role of takeovers in the Australian economy:

"The Eggleston Committee was also pointed out that while some regulation of takeovers was agreed to be necessary to ensure fair treatment of shareholders, it could not be said that takeover bids always disadvantaged shareholders. Moreover the possibility that a takeover bid will be made must operate as a spur to management to improve its performance and to disclose to shareholders the true worth of their holdings.

I would also add that in a free enterprise economy such as ours, takeovers can play a very important role in the efficient allocation of resources. In many instances, takeovers allow for the introduction of new and better management and technology and for economies of scale. This means a greater return on investment which is to the benefit of shareholders and provides greater security to creditors. Overall, there is a net benefit to the nation through the better use of resources. The government does not wish in any way to inhibit such takeovers. Indeed the proposed new takeover code which is directed at those apsects of takeovers which affect the efficient operation of the securities market will ensure national treatment of this matter in the same way as the Industries Assistance Act and the Trade Practices Act ensures a national approach to matters with which those acts are concerned."

Later the Minister stated:

"Consistent with its industries assistance, and trade practices policies, the Government does not seek to hinder beneficial takeovers. However, in order for resources to be allocated, in the most efficient way as a result of a takeover, there needs to be adequate information freely flowing between the parties. This allows informed decisions to be made by investors as to the best allocation of their funds.

The statement by the Minister, namely the concepts of the market place viewed as a prophylactic against a poor and inefficient management and the takeover viewed as a better allocation of resources, are now seen in Australia as the basic philosophy of the takeover legislation – something which Professor Manne in the United States of America had forseen some years earlier.

In Australia, we have rejected the theory developed by Professor Manne that the market place should be the complete substitute for disclosure laws. Rather we have emphasised that disclosure laws should complement the forces of the market place.

In short, the Australian theory is that if the conrol of the companies is to pass as a result of stock market transactions, those transactions should take place in a market which is efficient, competitive and well-informed.

May I say on behalf of the Commission that it welcomes very much the opportunity of discussing with the Securities Institute of Australia, matters of mutual concern and the opportunity of explaining public policy considerations where public stock ownership in a corporation is concerned.

The Commission believes that it is in the public interest to have an effective and efficient secondary market in securities. The process of capital formation depends for its very existence on informed investors and a secondary market in which investors have confidence. If investors do not believe that they can dispose of investments readily and at a fair price they will be loathe to make the initial investment. Investors must have confidence not only in fair and open trading, but also in an equality of opportunity.

In fulfilling a regulatory role the Commission must constantly consider how public confidence in the secondary market in securities can be instilled and maintained. This is a matter of concern, not only to the NCSC, but to the stock exchanges themselves. This confidence depends on rules, applied to all, which are not only fair but which are also seen to be fair. In particular, the public investor will be concerned if the rules permit him to be disadvantaged by an insider or control group – equal access to information is essential. Also critical to the process are rules which ensure that all participants deal on the same basis. A loss of confidence by individual investors in the securities market as a result of the conduct of acquisitions, particularly in the takeover scene, poses signifigant harm to the public interest. Until now regulatory provisions have not always provided adequate protection against such potentially deleterious effects. Accordingly, both the Stock Exchanges and the NCSC have a common interest in ensuring that the new regulatory proposals are well understood.