

TECHNIQUES OF REGULATION OF SECURITIES MARKETS IN A MIXED ECONOMY

by

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Mr. Leigh Masel presented the following address to students in the Victorian Division at the opening lecture in the Diploma Course subject, Introduction to the Securities Industry, February, 1983.

The National Companies and Securities Commission will have been established three years next month and it may be an opportune time to discuss with you the nature of the philosophies which guide it in its appointed task of companies and securities regulation.

There have been no changes in the composition of Members of the NCSC since its inception although Mr. John Uhrig, who is a part-time Member of the Commission and whose term of appointment expires in March this year, has indicated to the Ministerial Council that he does not seek reappointment and consequently a new part-time Member will be appointed to the Commission.

As you are all aware, the NCSC is responsible and accountable to the Ministerial Council which originally consisted of the Commonwealth Minister of Business and Consumer Affairs and the six State Attorneys-General. The Ministerial Council now comprises the Commonwealth Attorney-General and each of the State Attorneys-General. The NCSC has witnessed several changes in the composition of the Ministerial Council, and of the Members of the Ministerial Council who held office at the time of the establishment of the NCSC in March 1980, only one Minister continues to serve in that capacity — he is the Hon. I. Medcalf, the Attorney-General of the State of Western Australia. The NCSC has also witnessed changes of Government in Victoria, South Australia and Tasmania (bringing with it changes in the Ministers of each of those States), changes of Minister in New South Wales, Queensland and the assumption by the Commonwealth Attorney-General of duties which had hitherto been borne by the Minister of Business and Consumer Affairs.

It may very well be asked what policies does the NCSC espouse, and do these policies change as a result of changes in the political spectrum. As you are all aware, the NCSC was established for the purpose of providing uniform administration of company law and regulation of the securities industry, which hitherto had been administered on a State-by-State basis. In July 1981, the

NCSC administered for the first time two of the other substantive Acts or Codes as they are called — the Securities Industry Code and the Companies (Acquisition of Shares) Code. In July 1982, the NCSC began to administer the new Companies Act.

To the question which I have posed, as to whether policies of the NCSC change with political personalities, I believe the answer is that the Commission is apolitical and administers policies which are consistent with those to be found in mixed economy such as Australia. We use the expression "mixed economy" as meaning an economy in which it is found necessary to exploit some of the co-ordinating techniques that characterise both a market economy and a planned or command economy in order to carry out the basic economic functions of Government. One of the basic economic functions of Government is to ensure that scarce resources — in the context of company law and securities regulation, capital — is allocated efficiently amongst alternative users.

Mixed economies, both at macro and micro level, employ many techniques, both direct and indirect, in order to carry out the economic functions of Government. Macro economies deal with national income analysis — aggregate flows such as gross national product, national income, aggregate investment and total consumption as well as the relationship among these aggregates and the means to adjust them. Macro economics involves mainly instruments that have direct impact on aggregate demand, particularly taxes, money supply, credit constraints, Government spending. The NCSC is not involved with regulation at macro level. At micro level a mixed economy is concerned with determining how the market or price system allocates and distributes particular goods and services among subsystem units. Intervention at the micro level is both direct and indirect. Techniques of direct intervention at micro level include subsidies, tax incentives and disincentives, price support systems, tariff, import/export restrictions, foreign control and foreign investment restrictions.

Yet the NCSC is not involved with any direct intervention at micro level. But closely allied to direct techniques at micro level are methods of indirect intervention used by Governments, where persons are given a specifically circumscribed monopoly subject to the conditions that they furnish services to all members of the public on equal terms and that they comply with policies of the licence granting authority — policies that are generally determined in accordance with broad public interest, convenience and necessity standards. Examples of persons being given a specifically circumscribed monopoly licence subject to the conditions which I have mentioned are licences given to those members of the accounting profession who are qualified to carry on audit functions and also those persons who carry on business in dealing with securities. In the first case, an accountant who wishes to carry on the function of an auditor must register as a company auditor and must fulfil the necessary pre-conditions which are laid down in the Companies Act. In the second case, persons who carry on business as dealers in securities and their representatives are required to obtain a licence under the Securities Industry Act. Also at micro level, mechanisms have been devised that attempt to minimise market imperfections by Government policies with a view to protecting investors and consciously designed to give the objectives of stability and investor security at least equal status with market efficiency. The technique so utilised, is not to displace the market but to ensure that a constrained market works better.

Perhaps the best example of combining market efficiency with equality, fairness and justice can be seen in the National Takeover Legislation which has now been operating since July 1, 1981. It is an example of the central theme in the theory and practice of business regulation in a mixed economy — that it is both legitimate and necessary to place limits on the pursuit of economic gain, to intervene in the operation of the free market "in order to promote identified public objectives". It recognises that whilst economic activity is essential to the general welfare, economic activity does not, of itself, constitute or guarantee that welfare. At a certain point it recognises that there can be a divergence between priorities of participants of the market and the priorities of the society at large.

In the field of regulation of takeovers, Governments seek to reconcile conflicting goals, that is to say, free market forces and social values such as equality of opportunity and fairness. They do so by striking a balance by preserving the benefits of economic activity whilst at the same time promoting public interest considerations. The balance to be struck in takeover regulation is to allow or enable takeover activity to fulfil its economic function which necessarily involves takeover participants pursuing what they perceive to be in their own economic interests. In economic terms, an offeror and shareholders

of a target company stand to gain. The successful offeror will have the opportunity to optimise the use of the resources of the target company and members of the target company stand to gain if the bid is made at a premium. Also capital is a scarce resource and the threat of a takeover is seen to provide a unique stimulus to the efficiency and profitability of the company under threat and to operate as a spur to management to improve its own performance and that of the company. The threat of a takeover is seen as a situation where the concepts of the market place are viewed as a prophylactic against poor and efficient management and as a catalyst for a better allocation of resources. However, regulation ensures that shareholders who are affected by takeovers are protected. That protection takes the form of firstly ensuring that important information in terms of decision-making is made available to shareholders of a target company and that both directors and shareholders of the target company are afforded a reasonable period of time to evaluate the adequacy or otherwise of an offer.

The second form of protection is to ensure, as far as possible, that directors of the target company fulfil their legal duties which require the company's affairs to be conducted for the benefit of members as a whole and to encourage tactics which are designed to produce higher prices from bidders and which can only be to a member's advantage and to discourage defensive tactics which are designed merely to frustrate takeover offers and which may cause economic loss to members.

Takeover regulation is of course concerned with the operation of secondary markets and is designed to ensure that such markets are efficient in the sense that the price of the securities is sensitive to a flow of readily available information and that the transfer of ownership is effected quickly and economically. It is consistent with the principal objectives of securities regulation of which it forms part — namely, that it is to the benefit of the economy that confidence in the securities market exists so as to create an environment which will induce greater savings and in particular greater investment of existing savings in equity and long-term securities, to encourage Australians to acquire securities issued by Australian Corporations; and to generate sufficient market activity so that an investor can realise his investment at its full value at any time.

A second technique of indirect intervention at micro level is to institutionalise responsibility by ensuring that directors, professional managers and majority shareholders will use their powers fairly and in the interests of the corporation as a whole. Many of the provisions of the Companies Act do just that. For example, officers of a corporation (which of course now include Directors) are required to act honestly in the exercise of their powers and the discharge of the duties of office. An officer of a corporation is also obliged in terms of the Act to exercise a reasonable degree of care and diligence

in the exercise of his powers and the discharge of his duties; that is a case of institutionalisation of responsibilities in a general sense. In a particular sense, Directors have responsibilities in relation to the financial statements. They are required to present financial statements at each Annual General Meeting, and, in most cases, together with an Auditors Report. The financial statements must be accompanied by a Directors Report which must comply with the detailed provisions set out in Section 270. Then again, responsibility is institutionalised by the Act in that an officer or an employee of a corporation is prohibited from making improper use of his position to gain advantage for himself or for any other person or to cause detriment to the corporation. Section 556 of the Companies Act makes it an offence on the part of any person who is a Director of the company, or any person who takes part in the management of the company, to permit the company to incur a debt if immediately before the time when the debt occurred there are reasonable grounds to expect that the company will not be able to pay all its debts as and when they fall due.

Rights and responsibilities are also conferred on shareholders. For example a member of a company who believes that the affairs of a company are being conducted in a manner oppressive to one or more of the members, including that member, or that the Directors of a company have acted in relation to the affairs of the company in their own interests and not in the interests of the members as a whole, or in any other manner whatsoever that is unfair or unjust to one or more of the members, may apply to the court for appropriate orders.

The third technique which is utilised in mixed economies at micro level is the creation of an external agency with power to supervise markets such as the securities markets. The North American securities markets have been subject to external regulation for a number of years and the Federal Regulatory Agency in the United States, the Securities Exchange Commission, provides an example of a Regulatory Agency exercising regulation making, administrative, investigative and adjudicative powers to supervise or constrain the activities of those regulated. The NCSC is also an example of an external public sector agency established to supervise markets. For example, under the provisions of the Securities Industry Act, it may suggest to a Stock Exchange that it should prohibit trading in particular securities in the stock market of a Stock Exchange if it has formed an opinion that trading should be so prohibited in order to protect persons buying or selling the securities or in the interests of the public. Stock Exchange business and listing rules, which originally were enforced on a consensual basis by the Stock Exchange can now be enforced in a court of law on the application of the NCSC, the Stock Exchange or by a person aggrieved by the conduct of any person who is under an obligation to comply with, observe or enforce or give effect to

the business rules or listing rules of a Stock Exchange and who fails to so comply. One could go on for some time providing examples of each of the three techniques which I have outlined.

Apart from the question of uniformity of legislation and administration, the Australian Co-operative Scheme for companies is unique in that it provides a unified system of external regulation not only for the affairs of company and conduct of such affairs by Directors and Officers, but also of securities markets including the acquisition of parcels of shares in publicly listed companies large enough to influence the effective control of such companies. In this sense, the system of regulation differs from the sort of regulation still administered in the United Kingdom where the activities of market participants are almost entirely left to the oversight of self-regulatory bodies such as the London Stock Exchange, which exercises a general power of supervision of the conduct of its members, and the panel on Takeovers and Mergers which administers the City of London Voluntary Code concerning takeovers and mergers of Companies.

However, both in Australia and in England, regulation of the activities of companies as well as the regulation of securities markets and the industry have common origins. For example, many of the theories relating to regulation of companies and securities are derived from the separation of ownership of shares from management control. In the earlier stages of commercial and industrial organisations (including the so-called "cottage" industries), the ownership and management of the enterprise coincided. All this changed with the rise of the modern corporation whose origins date back to the Industrial Revolution. The demands for capital now greatly exceed the combined resources of savings of the original owners and the wealth-creating potential of the enterprises themselves. Invention, the growth of technology, enormous improvements in communications and the means of transportation, the exploitation of greatly expanding markets and so on have made it necessary for industry to tap the savings of the community as a whole. As a result, in Western societies, including Australia, we have witnessed the growth of sophisticated securities markets and credit granting institutions that are designed to serve the financial needs of large corporations.

It is a fact of life that in the modern corporation with fragmented shareholdings, control is exercised by a compact group of highly professional individuals. As a result, many of the duties and responsibilities which originally fell on Directors have been expanded to include officers.

Whilst regulation in the area of company law administration and regulation of securities markets is complex, there are two discrete threads which can be detected. The first is the aspect of accountability on the part of pro-

fessional management to Directors and by Directors to all those who claim to have an economic interest in the corporation. The second is the establishment and maintenance of an informed, competitive and efficient market which permits market participants to make effective economic decisions.

Accountability is a very large subject. For example, it is reflected in the requirements of the Companies Act relating to financial statements prepared by Directors and attested by Auditors. In order to discharge their responsibility to investors who entrust to Directors the control of their resources, Directors are required to furnish financial statements which, in order to be useful, should disclose sufficient financial and other information about the company's operations and its economic resources to enable parties who contemplate entering into contractual arrangements with the company to make effective economic decisions. Companies in the private sector operate for the purpose of creation of wealth. However, they are entities which are created by statute, and it is this status which gives them the privileges of limited liability, ability to raise capital from the public (subject to fulfilment of certain requirements), and freedom for their shareholders to buy and sell securities of that corporation in public organised markets. Governments are concerned that corporate wealth should be created and accumulated in an ethical manner and in accordance with those legal responsibilities laid down by the legislature. Governments also seek to create a climate for effective decision-making leading to the optimum allocation of scarce financial resources. Whilst Governments do not directly intervene in the allocation of scarce financial resources, Governments are concerned if funds are denied to companies who can use these funds profitably or who are producing goods and services desired by the community.

The NCSC is typical of those bodies when Governments find it necessary to channel market forces with a view of influencing the structure and operations of an industry, such as the securities industry. A commission, such as the NCSC, has been given a broad spectrum of policy-making, adjudicative and investigative powers and is perceived as an agency, created by Governments to:

1. Resolve detailed problems with which the legislature itself could not or be expected to cope;
2. Exercise adjudicative powers based on its own investigations and expert analyses;
3. Obtain information to which a court would not ordinarily have access; and
4. Measure and lay down standards for performance within the industry it regulates.

A regulatory commission such as the NCSC is controlled:

- (a) By its enabling legislation;
- (b) By budgetary constraints;

- (c) By accountability to Ministers; and
- (d) Judicial oversight on questions of interpretation of not only its enabling statute but also the statutes which it administers.

It is not a court but most people would agree that courts are not suitable vehicles for achieving broad economic and social objectives. The judiciary cannot initiate action. This depends upon the action of private parties or the Crown. It depends upon evidence furnished. The courts have no powers of investigation or of making economic analyses. The Courts have no continuing obligation to exercise surveillance over operations of any given market in order to determine whether policies laid down by the legislature are working or whether they need adjustment. The lengthy appellant mechanism inherent in the judicial process precludes courts from achieving reasonable uniformity of policy.

The statutes administered by the NCSC reflect a divided commitment on the part of legislature both to a regulatory commission and to the court. For example, under the Companies (Acquisition of Shares) Code, the Commission is empowered to take action in the event that it forms a view that breaches of the statute have taken place. However, it is to the courts that the Commission looks to for orders restraining the offending party from taking advantage of benefits which would otherwise flow from conduct deemed by the Commission to be illegal. An interesting innovation was introduced recently under Section 60A of the Companies (Acquisition of Shares) Act which provides that where the NCSC has declared an acquisition of shares or other conduct to be unacceptable under Section 60A, it is empowered to make certain administrative orders until an order from the court can be obtained.

One of the criticisms made of economic regulation in Australia is that the very nature of regulation of economic activities through detailed legislation has placed the Australian courts in a position of having to adopt a literalist approach to the interpretation of such legislation. There is a concern often expressed that the technique of drafting the statutes in detail such as we find in Australia, may contribute to a reluctance on the part of the court to examine the normative behaviour of participants in organised markets or to examine the underlying bases of economic transactions. There is also a concern often expressed that form, as distinct from substance, governs. Indeed, it would be unfortunate for the community if the case law which emerges from complex legislation such as the Companies (Acquisition of Shares) Act obfuscates more than clarifies, or if the courts are seen to endorse and/or perpetuate a maze of contradictory principles.

In an excellent paper given in 1974 Professor Maureen Brunt entitled "Lawyers and Competition Policy", wrote in the context of the then new Trade Practices Act as follows:

"Yet whatever the justification of the court's decisions and approach in the past, very fundamental questions are raised as to the contribution the courts might make to competition policy in the future. They centre upon the appropriateness of courts of law to handle economic subject matter, to adjudicate upon issues intimately concerned with the public interest and to interpret statutory language in the field of Government policy rather than in terms of received categories of common law thought. They raise the question of how — or even whether — words may be found for the statute that so blend economic and legal concepts that the law may be used for purposes of economic policy... The core problem is that, in this field, procedural and substantive law are both important and intermixed, as also are economic and legal concepts and skills. In Australia we have the further problem that the

law as a discipline is much more contained than in the United States, more inward-looking, more governed by precedent, more narrow in interpretative practice."

I have endeavoured to deal in a rather broad fashion with a number of important general themes touching Government regulation of economic activities. I have dwelt briefly on the subject of regulation in a mixed economy, the difficulty of reconciling generalised statements of principle on the one hand with detailed prescriptions of behaviour on the other and the appropriateness of courts of law to handle the task of economic regulation.

I hope that this address will have achieved its purpose — to canvass with you a number of complex issues and to ensure that the nature of regulation of business activities in a mixed economy is better understood.

BOOK REVIEW

HANDBOOK OF AUSTRALIAN CORPORATE FINANCE

Edited by

R. Bruce, B. McKern and I. Pollard

The introduction to Handbook of Australian Corporate Finance states —

"This book is concerned with the acquisition of funds by corporations.... The emphasis is pragmatic; is less concerned with theoretical issues and more concerned with the instruments, institutions and mechanisms involved in obtaining funds to support the activities of Australian enterprise"

Readers who bear this in mind should have little cause for criticism of this welcome addition to the shelves of both students and practitioners.

The establishment of the Campbell Committee resulted in an unprecedented volume of information on the financial system and the Handbook goes some distance towards bringing together in a cogent fashion the essence of much of the recently disseminated information pertaining to corporate finance.

With in excess of 20 contributors to the Handbook the quality of the various chapters naturally varies.

The Handbook has been divided into 5 sections:

1. THE AUSTRALIAN FINANCIAL SYSTEM
This section deals with the banking and financial institutions, monetary policy, interest rates and the availability of credit.
2. EQUITY CAPITAL
This section considers the role of the stock exchange

and the financial characteristics of Australian companies, raising equity capital and mergers, acquisitions and takeovers.

3. SOURCES OF DEBT IN AUSTRALIA
Chapters in the section deal with trading bank finance, merchant bank finance, sources of long term corporate debt, equipment leasing, the financing of inventory and accounts receivable and project finance.
4. INTERNATIONAL FINANCE
The international financial system, borrowing from overseas and international trade finance are covered in this section.
5. OTHER ISSUES
This section deals with the futures market, taxation aspects of corporate finance and corporate reconstructions.

Specialist corporate financiers when reading the Handbook will experience a certain *deja vu*, but should find it a useful reference. Students, corporate executives and those seeking an overall view of the subject will find the Handbook to be a very good investment at \$39.00 (\$29.00 Paperback)

The Handbook should be kept from those instant experts, sent by foreign shareholders to grace our shores, as they will become completely insufferable after delving into the Handbook and informing the natives that Jas Hardie had 244 shareholders in 1953-54.

J.M. Clugston