REGULATION OF PROSPECTUSES AND FUND RAISING ACTIVITIES THROUGH PRIMARY AND SECONDARY MARKETS

by

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"If fools went not to market, bad wares would not be sold." — Old Proverb

Such a statement may seem a rather cynical stance from someone the best part of whose working life has been devoted to providing protection for investors. It may be better seen as a hint of exasperation at the extent to which some investors either trust naively in the honesty of salespersons or by implication believe that an official body such as the NCSC has so restrained avarice (or could aspire to do so) that even modest personal precautions need not be taken to protect their interests.

What particulary comes to mind are recent experiences with some offshore offers.

In the past year or so the freedom of investors to move portfolio funds into and out of Australia has resulted in a significant broadening of market choice for investors with, as might be expected, mixed results. It has however surprised us that a reasonable strike rate has been achieved by several dubious operators whose modus operandi has been to secure a commercial client mailing list (frequently consisting of the names of those attending a professional seminar), to telephone those people from an overseas base, initially Amsterdam, but latterly Madrid, Gibraltar or Hong Kong, and solicit investment in investment products. If interest was shown but the deal could not be clinched over the phone, the contact could be followed up by mail with various impressive tip sheets. Alas, it soon transpired that many of the investments touted had rather less resale value than purchase value.

It is of course illegal to engage in a business of selling securities in Australia (including sending communications here) without a license under the Securities Industry Act, and securities themselves should, if offered to the public, be the subject of a registered prospectus. Following co-operation between the NCSC and overseas authorities the Amsterdam operation has been closed down, and certain individuals are now in goal in Hong Kong. Nevertheless the ease with which some money left our continent was rather reminiscent of the person who is miffed on a car being stolen after leaving it unattended for a lengthy period unlocked and with keys.

WHY A REVIEW

The mention of cars provokes the question why there is a good deal more official oversight on behalf of investors in securities than there seems to be for investors in new or used cars, and it is just such questions that will be directly addressed in the review of investor information now being undertaken by the committee established by the NCSC.

There is of course wisdom in the saying "If it ain't broke, don't fix it", and since recent times have seen a large number of new floats come to the public (Australian Business says that in the first eight months of 1986 161 new companies were floated in Australia — nearly one new company for each working day) and while miserable failures have been observed, spectacular scandals have not been easy to find. Could we leave therefore well enough alone? There is however more than enough noise to convince that a lot could be done to improve the information quality and speed in the system to assist both issuers and investors.

Issues which need addressing include:

There is a significant difference between the information processing requirements for offers of new securities and those for ongoing reporting requirements. Why?

It is said to take far too long to get an offering through the official system of corporate affairs and exchange listing departments, and there have been complaints of nitpicking by the regulators.

Avoidance of some requirements, like those concerning advertising and promotional restrictions, and the public offer rules generally, has become so widespread that, for some, compliance seems to be a voluntary activity.

We have heard that the detailed statutory requirements are telling us more than we really wanted to know about the peripheral, while significant issues are overlooked.

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Such criticisms justify a thorough going review of the system and I would therefore like to give you an overview of some of the issues being addressed by the Committee.

THE TASK: 1 — THE OBJECTIVES OF A DISCLOSURE SYSTEM

Because resources are less than demands for them, we must have a system of allocating available resources among competing demands. One way of doing this would be to establish a central planning authority to make the decisions. Our observations of the effects in those nations that have gone this route do not attract Australians to it. At the same time we have not been content to let the allocation decisions rest with pure market forces. When it comes to investment decisions, we look for efficient allocation in that the return in any particular case is equivalent to the return on other allocations with the same risks. Efficient decisions of that kind depend on adequate quantity and quality of information, and in particular information about the entity in which investment (or disinvestment) is being made.

Of course it is true that alongside information about the entity, the investor needs to take into account information about the industry in which the entity operates and about the economy as a whole, perhaps global as well as national. The Committee's study will not however concern itself with these collateral needs of investors: they are not needs that can be expected to be supplied in a satisfactory way by those competing for resources, nor can they be produced in a systematic way by a government authority such as the NCSC whose concern is focussed on specific entities (although in the longer term it should be practicable to build a data base which provides access to information statistics from material held by the NCSC and its delegates). Our concern will be directed towards information about the specific entity.

At all events it seems elementary that the most efficient allocation of resources should occur when information available to decision makers about investment products is sufficient for the purposes of the decision, and is also reliable and timely. The investment decision makers themselves are a variegated lot. Some (with a rapidly increasing investment power) are professionally equipped to analyse relevant information. Others, if the example I mentioned at the outset is representative, seem to have more money than sense. Our attention must be given to investment decision makers at both ends of the spectrum.

That disclosure and verification requirements for securities information for the benefit of investors are part of the government apparatus in many nations where capital markets are developed is undeniable. While these societies are therefore agreed in principle about the need for some form of mandatory specifications for the securities information market, it is worthwhile once again stating the principal reasons for this. They are, in short:

1) Securities are not merchandise information about which can be obtained by simple investigation by the buyer however expert.

2) Reliable and timely information sufficient to the needs of those who have capital to allocate is essential to the efficient allocation of resources in the economy.

3) Market forces and self-interest (the invisible hand allegedly invented by Adam Smith) cannot be relied on to provide the information in the quantity and time required.

4) Absence of mechanisms to secure true, complete and up to date information would lead to the perception or actuality of investors making decisions which would not have been made had better quality information been accessible. This would raise concerns about justice, and threaten the framework of trust that underpins commercial dealings in our community.

Relatively recently the third, and also the second, of these propositions have come under challenge.

It has been suggested that market forces in the form of demands by research professionals on the one hand will coalesce with the interests of securities issuers in maintaining a good market for their securities on the other to persuade the latter to provide the necessary information. This information would quickly flow into market prices enabling investors to be confident that the market price was appropriate to the risk and return. This efficient market hypothesis could then be combined with the suggestion that individual investors should minimise their risk by portfolio purchases rather than investment in specific stocks. The more moderate proponents of these market forces theories would admit, I think, that they really are fully applicable only to the most widely traded securities. They are of little help in choices confronting an investor when offered a new issue of securities.

Having allowed therefore for presuppositions on my part that good quality information is essential for an efficient and fair market for securities, and that it is unlikely to be produced voluntarily, it is the task of the NCSC Securities Information Review Committee to analyse critically the present system of raising funds by the private sector, and the role of the NCSC and its delegates in that system, in order to determine whether it effectively meets the needs of investor confidence and capital efficiency and to recommend whatever changes seem appropriate.

The Commission believes that if such an examination is to be useful, it is necessary from the outset to have input to the working party from other than government officers. Accordingly we have assembled a committee which includes, in addition to NCSC staff and Corporate Affairs officers, Neil Cole, the editor of JASSA; Graeme Little, a director of Second Board Consultants; John Rendle, a director of Macquarie Bank; and Robert Strong, formerly General Counsel of the NCSC before returning to private enterprise and merchant banking.

At a more philosophical level, we have asked Professor Don Harding of UNSW to prepare a paper on fundamentals of public disclosure.

Professor Harding will deal in particular with the application of the efficient market hypothesis, and open up some options for reform.

The time frame set for the working party has received a series of setbacks. The most significant of which was the diversion of NCSC resources to a public hearing. That task cost us approximately five months, and we had barely begun to regroup our forces when the senior staff personally most closely engaged in the review was headhunted to the private sector. It now seems impossible to hope for significant progress until well into 1987.

THE TASK: 2 — THE ENVIRONMENT AND THE INVESTORS

It is obvious that we will not be able to recommend a level and style of information that will serve alike the requirements of all investment decision makers. Some would say that we should ignore the unsophisticated: that those without the ability to assess an investment should seek professional assistance, and if they fail to do so, they should bear the consequences.

That argument sounds fine at a theoretical level. In practice, unfortunately, it is often not a matter of fools who go to market, but of the market which seeks out the gullible. While therefore we should aim to produce information that can be professionally assessed, we cannot simply abandon the needs of ordinary individuals who will have investments pressed upon them. To do so would be to abandon justice to those strong enough to seize it and set loose forces that ultimately would destroy trust in our system. I steadfastly set my face against the bankers and others who volubly advocate this approach.

The question of "who" is inextricably related to the question of "what". While 1986 has provided evidence that direct approaches by unseasoned companies to individual investors and huge rights issues are both more than viable means of obtaining funds, the Committee can ignore other trends, many of which are related to the internationalisation of the world's securities markets.

A good example is the recent issue of US dollar floating rate notes in the Australian market by BHP. Both the foreign currency denomination afforded to domestic investors, and the large amount of the private placement are pointers to current state of the art in securities markets and the relevance or otherwise of existing prospectus law. While this issue was made locally, the international marketability of the securities is plain.

Such internationalisation of markets is presenting new questions to the Commission on a range of issues. We are far from willing to be placed in that category of regulators whom the Economist described a few months ago as "stuck inside their national boundaries" with the result that "if a market has inadequate disclosure rules ... money managers will take their business elsewhere".

These developments make it necessary to undertake a broad view of the relevance of the information set needed for the market. To commence the task of identifying what information is relevant the Committee will make some enquiry about current trends in fund raising by Australian companies, particularly in an international context.

We have accordingly decided to ask an outside consultant to prepare a paper for us on this topic. The objective of the paper would be to consider issues such as general trends in the pattern of flow of funds between fund raisers and capital suppliers, trends in the overall level of fund raising by Australian corporations (as measures against GDP), and trends in the composition of fund raising.

This paper would also examine overall trends in debt relative to equity in the non finance sector and make a particular study of innovations in modern debt securities, such as floating rate notes of the kind just mentioned, convertible bonds, questions arising from "securitisation" practices and the like. From this study we should be able to discern trends in the overall importance of fund raising using securities regulated by the co-operative scheme legislation in comparison with securities not so regulated. Some conclusions may be able to be drawn about whether the legislation is regulating a shrinking component of the market and if so, what specific targets the existing legislative strategies should be aimed at, as well as identifying the new objects before designing new legislative strategies.

THE TASK: 3 — INDIVIDUAL INVESTORS AND THEIR NEEDS

The traditional target of securities regulation has been the personal investor. The Committee will therefore examine current marketing practices in relation to the personal investor. The Victorian Government has also funded a survey of individual investors. The sampling has already been undertaken and results are expected shortly.

Advertising merits specific treatment. The 1961 Companies Act provided strict limitations on advertising outside a tombstone announcing a prospectus. In 1971 this was reinforced by prohibition on news stories being fed to the financial press to assist marketing, and in the 1970's strenuous efforts were made to enforce these rules.

The attempt to regulate media priming has over its fifteen years of existence been a substantial failure: any revision of the law in this area must concentrate on directing publication of remedial information rather than continuing the fruitless effort to restrict journalists from plying their trade. No matter how lazy the story or what blandishments have been given to provoke the publicity, freedom of the press is sacrosanct.

The co-operative scheme legislation left the advertising rules intact on the face of the legislation, but in the light of the comments of the Campbell Committee the NCSC began to use its discretionary powers to relax the requirements for various classes of issuer. The exemptions have created their own marketing pressures in a generally deregulated financial sector. The result is that, so far as I know, there have been no prosecutions in recent times for breaches of advertising laws under the Companies and Securities legislation, although it would not be too difficult to identify contraventions if enforcement units of the scheme felt officious about it. The running in this area has passed out of the hands of the NCSC and CACs to the TPC, which recently issued its own policy guidelines on the subject.

My assessment of the position is that the present advertising structures under our scheme legislation are no longer enforceable or even desirable, and that the law will inevitably be altered to reflect a more liberal approach to marketing. As a minimum, the ordinary rules relating to false or misleading statements will always apply whether enforced under securities or trade practices law; it would also be reasonable to prohibit informal publication of information not derived from the prospectus or other notification incorporated into an official file.

Direct mail, telephone, and door to door cold calling present a more significant opportunity for over optimistic selling practices. These were also a significant concern in the UK of Professor Gower in his Review of Investor Protection which was published in 1984. The Securities and Investments Board have issued draft rules which may offer some inspiration for our committee. "Cold calling" will be allowed in the UK for the purpose of selling life insurance and authorised unit trusts, or if the person being cold called is a business investor, professional investor, or has entered into a customer agreement authorising unsolicited calls. Cold calling shareholders in a takeover bid or for the purpose of futures trading would be two examples of prohibited activities.

The remaining marketing issue that will be examined from a disclosure point of view is the role of investment advisers and securities analysts: in this connection what will be significant is the part played by the "independents". The role of salesmen for a particular issue is clear.

It may be assumed that analysts and advisers are in the business of discerning and retailing investment information and are therefore a significant link in the efficient market. However, it is precisely because discovered information can have a proprietary value that it cannot be expected that advisers will sidely disseminate, i.e. beyond their remunerative clients, any such information. In the Australian context at least, it seems unlikely that the influence of these people is so pervasive as to have a significant influence across the whole spectrum of the securities markets in bringing to light information that is both timely and reliable: on the contrary, the protection of a proprietary discovery element for clients means that these people could provide, in the absence of more general regulation of the market forces involved, significant inequities between investors that could have unacceptable effect on investor confidence generally. In the USA in at least one case (Dirks) the discovery and limited dissemination of information actually gave rise to a major insider trading case. However, common sense and some anecdotal evidence suggest that advisers and analysts who discover information from corporate sources are far more likely to make discoveries when the news is good than when it is bad. Reliance on analysts alone is therefore likely to be an uncertain guide for investors.

We therefore need to determine what should be the role of advisers and analysts in obtaining and using information, and to what extent the system should be designed to assist them in their function of intermediating complex information to less sophisticated investors.

THE TASK: 4 — THE ISSUERS TRAVAIL IN GETTING TO MARKET

Another significant area for study by the Committee will be the process of getting a new company to the stock market. One empirical input which has already been completed is an examination of the performance of unseasoned new equity issues from 1978 to 1985. This examination, undertaken by Frank Finn and Don Hamson of University of Queensland and Ron Higham of Coopers & Lybrand, examines the performance of 63 stocks. It does not include second board listings, as it was necessary to have a cut off of June 1986, at which time the second board sample may not have been representative. The study, which I hope will be published shortly, has the usual mathematical formulae that people like me skip. The average return to stags was shown to be 18 per cent or an average of $1.54 million. When property trusts were excluded, the average stag profit increased to 21 per cent. These results are significant because of their absolute size, and because of the suggestion that the average stag profit is higher in Australia than overseas. It raises the question whether companies are being well served by current standards and systems of intermediation for their float: does the sponsor and his clients get too much of the cream?

Before we attempt an answer to that question we will obtain better understanding of the underwriting process. A study paper will be primarily undertaken within the Committee by John Rendle of Macquarie Bank. The paper will describe the major players, the role of regulatory authorities and the rights issue process as well as prospectuses.

The paper will also deal with what are described as "compliance listings", listed trusts, back door listings, debt issues and make a general assessment of this element of the system and possible alternatives.

We will also be obtaining specific information from Graeme Little of Second Board Consultants, who has been responsible for many of the recent second board listings. An examination of the "going public" process would include interviews with solicitors, accountants and brokers to discuss their close encounters with that process including analysis of costs and suggestions for its improvement. A representative sample of second board company executives would also be asked for their views. Perhaps it may be possible for the study by Frank Fin & Co to be supplemented by a few second board comparisons.

THE TASK: 5 — THE REGULATORS

The committee will critically examine the role of the regulators in the securities issuing process —the NCSC and its discretions, the CACs, the stock exchanges and the interrelationships between them.

While the Committee will review regulatory practice generally, those of you close to the action will realise that there has been a significant shift already in NSW Corporate Affairs practice on prospectuses. In a recent circular the CAC offered some critical comment on the standard of draft prospectuses being lodged. Indeed one might suspect that some practitioners had been willing to have some of their responsibilities performed for them by CAC staff. The CAC has accordingly indicated that it now applies a procedure under which:

1) the first draft is not regarded as suitable for examination unless accompanied by checklists indicating where various compliance items have been satisfied;
2) priority will be given in examining those drafts accompanied by a statutory declaration as to compliance.

The CAC will place increased reliance on the checklist and declaration, and there will be some reduction in examination by the CAC. In fact only about 10 per cent of checklist answers will be further verified by CAC officers. This process in NSW is something of a trial balloon and will be reviewed by the Committee in the course of 1987 to determine whether it can form the model for a new regime under the legislation where examination by CAC officers gives way in part to certification by practitioners.

INTERNATIONALISATION OF OFFERINGS

The Commission has received several individual requests over the past twelve months for recognition of overseas prospectuses from the USA, UK and New Zealand, in one case concerning a petroleum offering, and others mainly relating to employee share schemes for multinational companies. The case by case approach to prospectuses from those countries has been sufficiently satisfactory for the NCSC to consider whether a general policy can be formulated.

It would however be desirable that our policy be keyed to reciprocal recognition for Australian prospectuses. Australia has need for the import of equity capital and the NCSC does not see it as necessarily being in the national interest to provide a relaxed entry to our securities markets when the favour is not returned. The position is further complicated in the case of international investment funds by questions of competitive neutrality. Australia has expended considerable energy on its system of trust deeds and prospectuses, and in the course of so doing has imposed not inconsiderable establishment and compliance costs on local promoters. The NCSC should therefore be cautious in accepting that an investment fund which might not meet Australian fiduciary requirements should be granted recognised access to the Australian investment market.

These international issues are particularly difficult for us because we have only a modest securities market when compared with North America and the UK. Nevertheless the NCSC is making substantial efforts to persuade the regulators in those countries to recognise our prospectuses. A more fruitful area of capital cross fertilisation may await us in New Zealand. Already that country provides some recognition for Australian prospectuses and the agreement for Closer Economic Relations provides a spirit for further improvements in reciprocity.

LIABILITY FOR MISSTATEMENTS

The question of liability for misstatements and omissions will receive significant analysis in our review. Proceedings for this form of contravention, whether civil or criminal, under the Companies legislation are relatively rare, although they are becoming more popular under the Trade Practices Act.

If a prospectus contains negligent misstatements the common law rules for liability would apply, and there could be liability unless some form of disclaimer were given. I have seen few disclaimers in prospectuses, but experts providing reports under the takeovers legislation frequently seek to disclaim their liability for negligence. Such disclaimers are not effective to remove statutory civil liability, as the legislation gives a right to compensation against those who authorise the prospectus knowing it contains a materially untrue statement or non disclosure.That liability is limited to those who invest in the faith of the prospectus, and would not apply, for example, to those who buy securities in the market, e.g. from stags, while relying on the prospectus information. The disfunction between the rights of those who invest under the prospectus and those who buy when the only market information is what is in the prospectus is a potentially serious blemish on our investor protection system and warrants remedial action. Even more serious is the large number of floats being brought to the public market where because a prospectus has not been required by the stock exchange, and all investors are deprived of their statutory protection.

Outside the prospectus provisions there are other statutory remedies available to investors, principally under the Securities Industry legislation. That Code prohibits the inducement of dealings in securities by false statements or dishonest concealment of material information and provides a right of civil compensation. A further means of redress may arise in South Australia and the ACT under misrepresentation legislation.

Perhaps potential liability under four different pieces of legislation as well as at common law is too heavy a burden, both for complainants and defendants. Rationalisation will certainly be an issue for the Committee, as well the question of whether the NCSC should on occasion be the civil plaintiff under the prospectus legislation generally, as it may be now under the Securities Industry legislation and those provisions of the Companies legislation that enable an award of damages for contravention.

DETAILED REQUIREMENTS FOR PROSPECTUSES

The precise contents for prospectuses are set out in a Schedule to the Regulations. Given that the contents may be varied by regulatory discretion those prescriptions are these days more like guidelines than hard and fast rules. Nevertheless the schedule will receive critical attention. We have in particular retained an academic consultant to prepare a paper for us on the Investigating Accountants Report.

The concept of a primary offer document for new securities, with periodic information supplied to investors under the Companies legislation or to the market in the case of listed entities seems ripe for review in the light of today's technology and the varying levels of desired research by investors. A way forward may be to create a publicly traded securities data file which is required to be updated on a continuous basis. The file would be open to public access and would be the basis of required disclosure. Securities issuers could then chose the extent to which their marketing documents extracted information from the public file.

A recognised data file of this kind could form the basis for determining to what extent the NCSC should preview material and prevent its appearance on public register or require it to be supplemented. It would also enable a decision about the extent to which stock exchange listing departments should require additions to the public file and how the two co-regulatory bodies should co-ordinate their overview. Similarly, the present methods used by some promoters of playing the exchanges off against the Corporate Affairs offices will be satisfactorily resolved.

Many of the issues of when an offer is one to the public would also be resolved by such an approach, because where open market trading is intended it would be necessary to establish a public data file.

Nevertheless the public v private question will continue to be a thorny one. I am convinced that the right principle to adopt is to define "needs". If an investor has information, or is in a position to bargain for information before investing to the extent access is not available to that information, then the offer is private. If not then it is public. In other words a public offer is one where the investor *needs* the protection of the statutory disclosure rules and official monitoring. A secondary issue is whether some liability rules should apply even to private offers.

CONCLUSION — BASIC DIRECTIONS

In a recent editorial in JASSA I suggested that as convenor or chairman of the Review Committee I could not pretend to come to the task with a mind devoid of pre-conceptions. Some of those preconceptions may have already been showing through today, but it may be helpful to develop them a little further.

I wrote then that I believed a standard of full and timely information is fundamental for an efficient and fair securities market, that such information as would be voluntarily produced in response to market demands would fall far short in many cases of the requisite standard, and that sole reliance on liability for false and misleading statements likewise would not produce the positive results required.

What then are the basic options for an adquately and appropriately informed securities market?

In an era of deregulation and privatisation one non-governmental approach would be to rely on the stock exchanges for the monitoring of the public data file, at least for listed securities information. The AASE has developed useful general and specific disclosure rules and has historically been in advance of the corporate affairs system in identifying and mandating the needs of the market. A similar pattern applies in some of the stock markets of North America and the UK. We should note however that there are several obvious problems: the exchanges do not cover the universe of publicly marketed securities and even issuers that do intend listing frequently need to release their offer document before clearance by the exchange. Additionally the exchanges while having a strong veto power at point of admission are far less capable of ensuring ongoing information.

The first layer of legal regulation must of course be criminal and civil liability provisions. The latter might perhaps be given a stronger bite by greater openness to class actions for which false public statements seem particularly suited. Even so the legal costs of investment of money in legal proceedings following an investment loss form a substantial barrier to purely private action. The next stage could be to enlarge the capacity of the NCSC to bring public interest proceedings. This enlargement would need to encompass not only legal authority but also budgetary funding.

The next layer of regulation involves specification of disclosure items, but without public filing, whether for preview or review. Such specification would basically aid subsequent legal proceedings in the case of complaint. A variation on the theme is also to limit the extent of publication of information which is incomplete. This is the current legislative policy for general advertising and cold calling.

Finally there are various modes of public filing, preview and review. We presently have a mixture of these without logical connection. My preconception is that these last three themes need to be rationalised, harmonised and developed to a symphony. The entire opus would then facilitate the efficient raising and allocation of capital while serving investors through assurance of the fairness (i.e. accessibility) and integrity of market information. Confidence in the terms upon which investors, whether individuals of modest means or large superannuation funds, are persuaded to decide the destination of their savings will be a significant influence on the future economic well being of Australia.

My hope is that the symphony will be found to be a fit work for the classic capitalist orchestral repertoire.