The CONCEALMENT, USE and DISCLOSURE of INFORMATION

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THE CONCEALMENT, USE and DISCLOSURE of INFORMATION

The economics of information

From ancient times to the present, information has made the world go round, from the most routine of transactions to the most complex. One critical issue therefore is what legal rules, if any, should govern the creation, dissemination and use of information. The importance of this issue predates the internet and even the computer. As befits the topic I will take a conceptual and abstract approach to my subject, and examine the issue of the legal regulation of information in the light of first principles. I will not be commenting specifically on New Zealand law, since I am only too aware of my lack of detailed knowledge in that field. Rather, most of my specific references will be to American laws, which enables me to criticise them vigorously without inviting trouble and confusion.

The serious study of information as an economic concept dates only from 1961, when a paper by George Stigler on the economics of information initiated a whole academic movement in this field. In one sense, information can be regarded as a class of property, analogous to other goods and possessions such as a sack of potatoes or a wrist watch. Yet information has some very strange characteristics. It does not come in discrete packets, and its content must always be verified and interpreted. Nor is it easy to create property rights in information. I can give somebody my watch, and then I can ask her to return it. When she has returned it, I can be confident that I have the watch in my possession

again. But if I give somebody a piece of confidential information, it is very difficult to know how that person could 'return' the information, because I cannot dislodge it from her head once it has become lodged there. Moreover, once she has received it, the information is capable of almost infinite replication, and may be given to other people under a wide variety of circumstances. Information is thus readily reproducible and divisible. Its possession is easy to acquire, but its exclusive possession is a struggle to retain. These special characteristics make it much more difficult to create and enforce property rights in information.

One aspect of this subject that I am not stressing today is the common wish of people to create property rights in information in and of itself, and not as an adjunct to some other transaction. In the area of intellectual property—copyrights, trademarks, patents and so on—much of the mission of the law is to determine the best means of creating and enforcing exclusive rights in such property. The pattern of exclusivity that emerges with these informational devices parallels in some, but by no means all, respects exclusive rights in land and chattels. If I were discussing those particular topics, I would look more closely at other aspects of the economics of information, and explain why the special properties of information sometimes make it desirable to create permanent and exclusive rights in this area. But my topic today is information in a different context, namely the way it influences how ordinary, routine transactions take place—for example the manner in which employment contracts are formed, sales contracts organised, partnerships in businesses undertaken or compensation schemes made and announced. I will also cover the issue of whether parties involved in seeking to promote the election of political candidates or parties should disclose information about the resources used in influencing the public.

There is no obvious solution to the problem of information. Indeed, in legislative terms, two philosophies—inconsistent in their basic structure—exist side by side on the statute book. My favourite illustration of this irony is the fact that in 1968 the US government passed two statutes, both of which were thought at the time to be desperately

important. One of these statutes was the Privacy Act, and the other was the Freedom of Information Act. Yet it turns out that we cannot have rules which in the same breath allow people to keep certain information private and require them to disclose it. That is one reason why this area is so difficult: one never knows whether confidentiality is the preferred position and disclosure is wrong, or whether the opposite is the case. Our task, then, is to seek to understand whether, in the case of information that can be easily reproduced and transmitted, confidentiality or disclosure is the appropriate background norm where this information is an adjunct to certain types of contract, such as those to do with employment relationships or various corporate transactions.

A point brought out in Stigler's 1961 paper is that, from the point of view of an individual, generally speaking, information is power. If a person has the choice of ignorance or knowledge, knowledge is typically preferred. The only kind of exception are cases where somebody knows that he has a 50 percent chance of having a deadly inherited condition like Huntington's disease and the issue is whether he wants to find out the truth. Here we enter a complicated field of psychology bearing on what people want to do with their own lives. But in ordinary commercial transactions, information is typically associated with power. The more information we have about the world, the more we can predict what is likely to happen, and the better we can estimate the consequences of certain courses of action. To the extent that our view of transactions is self-interested, the more reliable the information and the better our predictions, the greater will be the net return from our various endeavours.

In general, therefore, from the perspective of the decision-making individual, more information can be regarded as better than less. If that were the only consideration, we would expect to see an explosion in the acquisition of information. Indeed if information were literally costless, confidentiality would become impossible. No matter how hard somebody attempted to conceal a piece of information, the fact that it could be acquired at a zero price would always cause it to be uncovered. In reality, however, information that can be gathered and has value comes

only at a positive cost. It is this feature which makes information an interesting legal and economic problem. People must dig, investigate, search, or otherwise find things out. For any individual, information—at least as a first approximation—will be sought in much the same way as any other good: we will engage in activities to acquire it up to and not beyond the point where the additional expenditure of a unit of time or effort yields only an additional unit of benefit. In this process, we always decide to quit before we have certainty. Often we will rely on various estimations and probabilistic techniques, since—at least beyond a certain point—computation of this kind becomes more reliable than additional search. One of the characteristics distinguishing a rational actor from one who is less successful is the rational actor's better sense of exactly how these trade-offs work. The more powerful our theories, the less 'information' we will actually need. There is thus a substitution relationship: we can invest either in understanding how to draw inferences from scattered data, or we can invest in obtaining more plentiful data which will yield explanations on the basis of relatively less powerful theories.

Externalities in information

This analysis offers a rough understanding of how a private equilibrium is reached in the acquisition of information. But we still need to ask whether that private equilibrium will correspond to the social optimum. This problem is not, of course, unique to information but comes up in relation to economic activity in general. For example, if somebody is maximising the value of a plant by engaging in certain acts of pollution, we will have a different attitude towards that pollution if the person doing the polluting is merely affecting his own property rather than the farm of a third party. In the first case the polluter stands to bear the cost as well as reap the benefit of his activities. Since there are powerful incentives for him to make the right decision, he can safely be left to decide for himself the tolerable level of pollution. But if his activities create harm to another individual, the optimality constraint is no longer satisfied: he will typically cause too much damage, because he will bear too little

of the cost. A sound system of liability rules would be designed to bring home to him the undesirable side-effects of his own action, so that he modifies his behaviour accordingly. Exactly the same type of problem occurs in the case of information. If the collection and dissemination of a given body of information has negative external consequences for other individuals, the optimal amount of information for one person operating in a private capacity will not necessarily be optimal for the social system as a whole.

We need, then, to go beyond individual tastes for information into social judgments about the type of information that should be allowed to be collected and distributed. Here we can draw another useful distinction, which again has parallels in other areas. Some harms are to individuals with whom we do not have contracting arrangements: in those external cases the problem of the creation of wrongs and the over-consumption of resources is serious. In other situations, information may adversely affect individuals who have previously consented to the relevant arrangement. At this point the damage is more in the nature of self-inflicted harm. In the former case we must analyse how information works in the context of externalities, while the latter case concerns how information, misinformation and incomplete information work in the context of ongoing consensual arrangements.

Defamation provides an instructive example of a negative externality. If I make a false statement about somebody to third parties, with the intention of inducing those parties not to enter into business with the target of my defamation, I have effectively created an arsenal of misinformation which will alter for the worse the terms of trade of the relevant individuals. Common law has long understood that a truth is often unable to catch up with a lie, and that false information will lead people to incorrectly evaluate arrangements they otherwise might have made. Defamation thus counts as a serious disruption of mutual voluntary cooperation. The fact that the harms in question are often economic, relational or associational has never deterred the common law from recognising these rights of action. It is understood that, under these

circumstances, one person's creation of misinformation means other people will act on wrong premises and make wrong decisions. We protect the reputation possessed by an individual against the false statements of others, and we do so on the grounds that misinformation creates negative externalities which can be discouraged by legal redress.

Indeed if an action of defamation is a deliberate lie, it has two wrongful consequences. First there is an effect on the person defamed and secondly there is an adverse consequence for the party receiving the misinformation. Moreover, the defamer herself is likely to spend positive resources in order to deceive the other parties. Since there is likely to be at least some suspicion that the defamer is lying, she may well need to expend resources in crafting misinformation that is not perfectly transparent. She will incur costs to create an additional cost in the form of disabling another party from entering into a variety of gainful transactions. Not only is she prepared to impose a cost upon the other person but she will also engage in deceptive conduct so that she is not obliged to compensate the other party. Very few fraud transactions involve somebody saying: "Mr Jones, I am now about to lie to you. In order to compensate you for the inconvenience of this fraud, I am prepared to pay you a thousand dollars". There are good reasons why the prohibition against false speech extends beyond defamation to cover cases of two-party fraud. In the case of fraud, the positive expenditure of resources by one party results in greater losses to two or more individuals, and there is no socially relevant reason why we should deal with it in any way other than by punishing the offender. The main question in those circumstances concerns the extent to which it is efficient to provide legal remedies for fraud, or whether the best remedy is simply a healthy dose of suspicion. In some cases legal remedies will not work. This, however, is not a moral objection to actions against fraud. It is a practical objection that the cost of rectifying a given class of fraud exceeds the harm it causes.

Closely related to fraud are cases of concealment, which are effectively fraud by conduct rather than by words. If somebody conceals the termites in her basement when another party comes to inspect the premises, the

analysis is identical to that of verbal misrepresentation. We can have misrepresentations by conduct, for which the common law rule is also absolutely unremitting. Concealment and fraud are treated as one: both are normally actionable by way of a prima facie case, and both are defences against the enforcement of a contract, should a party have been induced to enter into the contract on false premises.

When should information be disclosed?

The issue of disclosure, however, presents a far more difficult problem. If there is a material fact that another party wants to know, the issue is whether I am duty bound under the circumstances to disclose that information to the other party, so that an informed choice can be made about the relevant arrangement. The arguments in this case are much more complicated, because the relevant set of costs and benefits will vary markedly with the context. This is why the confidentiality-disclosure debate turns out to be so inconclusive if conducted at a very high level of abstraction.

Let us start with the simplest situation. Suppose somebody comes up to you with a bundle of goods, and the question is whether or not they are of merchantable or warrantable quality. The seller happens to know that they contain a latent defect. He puts them on the table and simply announces the price, which corresponds to the price for the standard items. He invites the prospective buyer to buy them. Under those circumstances, we can make a powerful argument that the entire nature and structure of that transaction involves an implied condition in the contract that the goods are of merchantable quality. That inference will only be strengthened if one party is a merchant who is routinely engaged in the sale of those goods, and the other party is an ordinary consumer. The common law rule for these types of implied warranty, both prior to sale of goods acts and since their introduction, has taken exactly that approach. The common law correctly perceives that the standard contract between two parties involves mutual gain. To the extent that I suppress certain key information, and sell inferior goods at the price of a superior

good, the mutual gain condition is no longer satisfied. I need not alter the goods themselves. It is sufficient that the buyer is disgruntled with the goods relative to the price paid for them. The person committing the fraud may disappear like a bandit, and there will be a general diminution of confidence in commerce.

Incidents of this type will lead to sellers being required to offer express warranties. Honest sellers like rules of this sort: they can then sell goods with a minimum of suspicion, while dishonest sellers will no longer be able to follow suit and have of necessity to rely on an evasive silence. Some dishonest sellers will be driven out of the market, and a more satisfactory equilibrium will emerge. Thus, to the extent that disclosure is necessary for business efficiency (to use the classical phrase), at least some forms of disclosure will be required. Specifically, we will require disclosure in those circumstances where it is necessary to promote exchanges that satisfy the mutual-benefit criterion.

We can now explore further the case of the sale of goods. Suppose the seller puts some goods on the table, and she is asked whether they are genuine New Zealand kiwifruit. This is clearly a question that may be relevant to the decision to buy. The seller could refuse to answer, leaving the customer to assume that the goods are probably not the genuine article. In that situation, most customers would probably not buy. Alternatively, the seller may confirm that the goods are New Zealand kiwifruit. But the buyer may still want more information. He might, for instance, ask for the name of the supplier. The seller, who was quite willing to warrant the soundness of the goods and the country of origin, may justifiably be very reluctant to give the supplier's name. She may say: "I can assure you they are New Zealand kiwifruit, but I'm not telling you where I got them from. My fear is that this information, which would confirm that I got them from a reputable supplier, would allow you to dispense with me as an intermediary in the next transaction. You would go directly to the supplier and buy the goods yourself. I expended considerable resources building up relationships with my suppliers. If I let you have that information, I would be giving you an asset which is

separate and distinct from the goods in question, and I am not willing to do so. It is enough for you to know that they are of good quality, that they are New Zealand kiwifruit as advertised, and that you can sue me if the terms of sale are not adhered to".

Once we realise that this is the way the express dialogue will go, we would not wish to read into the contract any implied term to disclose information of that type. For the same reason, if the seller bought the goods at an exceptionally cheap price, she would normally refuse to disclose that information to buyers, since it would assist them to bid down the price. We will tend to discover, therefore, that transactions in explicit markets will allow the preservation of some information by a seller or a buyer. Typically the information preserved allows sellers to keep the human capital they invested so as to be in a position to complete a successful transaction, but there will be voluntary disclosure and warranty of that information to assure buyers of the nature and quality of the goods being purchased.

Although that is the way efficient transactions will tend to work, we should not bind people to those rules. If people wish to disclose the name of their suppliers, or the prices they paid for goods, they should obviously be free to do so. But at least in a world of implied obligations, we should not set the default positions in ways that are counter to our standard economic expectations. We should certainly not force the seller to disclose the name of the supplier, or the price paid for the goods, as a condition of entering into a market transaction. This would merely reduce the probability of the transaction taking place at all, because we would effectively be expropriating human capital through the mandatory transfer of information.

These examples may seem far removed from some of the topics coming under the heading of 'information'. There is, however, an intimate connection between the logic of disclosure in these kiwifruit examples, where different rules would produce different outcomes, and areas that are subject to intense regulation in New Zealand and elsewhere, namely personnel contracts on the one hand and various stock and

securities transactions on the other. Let us see how the analysis of the common law applies to these situations.

Disclosure in employment relationships

The employment relationship provides us with a very similar problem to marine insurance. Marine insurance is an area dominated by very powerful norms of disclosure, but the obligations are not placed on the so-called powerful party—the insurer. The standard obligation has always been placed on the insured. The insured will have private information relevant to the nature and severity of the marine risk. If he conceals that information, the decision to undertake the insurance—or the premium charged—will be seriously biased. For that reason, most marine insurers will demand a series of express declarations. The background norm of full disclosure of all material facts regarding the scope and severity of the risk was established in maritime law long before it was made a default condition under various statutes earlier this century.

In the employment context, imagine an employer is about to make a job offer to a potential employee. If it is to be a satisfactory employment contract, it will be one taking place on mutually beneficial terms. In a voluntary market, what would an employer look for, and what would an employee be prepared to disclose? Since the mutual gain condition will be extremely important, the employer will obviously be very interested in the types of services and benefits the employee will be able to provide. For a start, she will be interested in what we loosely term 'qualifications'—this being a proxy for services she hopes to see rendered by the employee. Questions about qualifications would not normally be controversial. But the employer will also want information about the potential durability of the contractual arrangement. This may typically require questions about whether, for example, the employee plans to go back to graduate school. It may require information on age, or marital status, or whether the applicant has children, or plans to have children, and so on. This brings us into difficulties with the Privacy Act, at least in the United States, on the grounds that information of this type is

personal to the employee, and an employer may not demand it. Inasmuch as this approach assumes that the information is not relevant to an employment decision, it is clearly misconceived. From the point of view of an employer assessing anticipated benefits from an employment relationship, precise information on characteristics such as marital status will help signal its likely durability. It will also provide a better sense of the amount of effort that can be demanded of the employee during any particular time period. This information is admittedly stochastic. But all prediction is probabilistic, and we should never discard imperfect information if the alternative is no information whatsoever.

Thus the logic of contracting strongly suggests that employers in an unregulated market would ask for this information. Some employees would decline to supply it, in which case the prospective employer would be free to make a decision without it, or to deal with other employees who are prepared to supply the information. In some cases employees would supply it under terms indicating the probability of a highly profitable relationship, and a bargain would be struck that is decidedly attractive to both sides. In other cases the information might be mixed, and the compensation and guarantees and collateral terms may be altered to take all of it into account. But under both sets of circumstances, the wage itself would be accepted or declined by the employee on the basis of his assessment of whether he stands to benefit from the deal. The employer will be subject to the same constraint. Thus the labour contract has exactly the same asymmetry with respect to fundamental information that we observed in the case of marine insurance.

Under many circumstances, the employer may seek even more intimate and personal information from an employee. She may, for instance, be interested in whether the applicant has AIDS. The cost of health insurance for a person with AIDS, even given ideal medical care, is roughly 25 times greater than for an employee of the same age and same sex without AIDS. For an employer trying to cost out her health insurance premiums, this is a very relevant factor. Where a competent employee is afflicted with a disability, we cannot simply look at the benefit side of

the ledger. We must also take into account the cost side. Disclosure of an AIDS condition would not necessarily result in loss of employment, though it may well result in a change in the terms and conditions of employment. For certain short-term contracts, it may be unimportant, but any employer offering health benefits will know that the likely cost of medium-term cover has risen sharply.

What should happen to information on AIDS once an employer acquires it? Employees are often frightened about disclosing such information, because they wish to keep it from other individuals for whom it is none of their business. We can, however, have a mixed regime that requires disclosure to certain individuals, but which then requires them to hold the information in confidence from other individuals. Indeed many of the privacy statutes that refuse to allow people to acquire sensitive personal information apply only at the time of the original employment contract. The statutes require people subsequently to obtain the information and keep it in confidence, so that if, for example, a worker has an epileptic fit on the job, the employer will know what treatment to follow. Thus the partitioning of information admissible under statute leads to a different partitioning of information under contract. Moreover, there would be a very severe remedy for breach of contract if information received in confidence was disclosed to a third party.

Consequently, the regulation of these types of arrangements by privacy statutes is misconceived. Privacy rightly understood is simple: if people wish to keep information private, they are entitled to. But they cannot force other people to take a series of risks by forcing them into entering a business transaction while denying them information they regard as material. These days we not only have non-disclosure, we have prohibitions against asking questions—which paradoxically turns the privacy legislation in some sense into an instrument of fraud. An employer is barred from asking a question. She cannot get information known to be reasonable. Yet both parties realise that, in the absence of legal restraint, the question would be asked. If answered truthfully, in at least some circumstances the job would not be offered, or would be offered on

different terms. Proponents of the Privacy Act need to explain why they are prepared to force people to enter into losing transactions by imposing upon them collateral restrictions on their ability to acquire information relevant to their decisions. Moreover, once people find that they cannot get accurate information by asking questions, they will seek alternative sources by sleuthing around. Private investigators can be hired to advise whether or not a woman wishes to get married, have children, or leave town, or whether a man has AIDS. Forcing people to rely on bad information acquired at high cost, rather than good information at low cost, must be a mistake.

Some people object that we wish to ensure opportunities for people with disabilities. But if the government wished to intervene on behalf of people with disabilities, it could say to a firm: "You hire the worker. We will pay the cost of your insurance policy or otherwise subsidise the position out of public funds". This would ensure that the burden did not fall arbitrarily on a single employer selected for her willingness to take a chance, but would become a public obligation for a public benefit. Yet in America today, under the Americans with Disabilities Act, we have created rights that prevail in private employment contracts, and thereby reduced the number of jobs that firms are willing to offer people with disabilities. These misconceived laws are decidedly inferior to the common law rules.

Disclosure issues in company and securities law

When we come to the use and dissemination of information in the corporate setting, the logic mostly runs in exactly the opposite direction. Often there is a powerful contractual implication towards confidentiality. But the law, instead of enforcing that confidentiality, again gets it around the wrong way. Consider, for example, whether there should be disclosure of employee compensation—at least for key employees and large publicly-traded corporations. The American rule requires disclosure, but I generally refuse to read these disclosure statements on the grounds that the information is extorted from the companies rather than being revealed voluntarily.

In considering why companies do not choose to reveal the information voluntarily, we can look at this issue from three different points of view. There is the perspective of the individual employee, the shareholders, and the employer or board of directors. From each point of view, disclosure will be seen as undesirable. First, the employee usually does not want any information about his salary to be known. If other people are aware of it, they have better information about his potential as a target for everything from bribery to kidnapping. Even putting aside these extreme cases, the more other parties know about a person's income, the better they can target him for unwanted solicitations and guess his reservation price in many market transactions. Very few people go around saying: "My name is Smith. I earn $250,000 a year. I can afford anything I want". On the contrary: when Smith goes to buy a car, he does not walk in looking rich and famous. He goes in wearing ordinary clothes. He scratches his head as he ponders whether he could stretch to a luxury model even though he may be able to afford any price the dealer is likely to ask. In all sorts of situations people wish to keep their salary confidential. The law should generally respect their wishes.

If I am a shareholder, do I want this information? If it were personal to me, I might be happy to receive it. However, public disclosure is the last thing I would want, since when I receive the information everybody else in town would also get it. Valuable information on the employee structure of the firm I have invested in, and on the salaries being paid—information which was costly to create—will become a public good. Moreover, once outsiders have the information, the firm I have invested in will be disadvantaged. Predators will be in a much better position to plan their recruitment of my key employees. So as a shareholder I do not want that information to go out either. And if nobody inside the relationship wants the information made public, I fail to see why it should be forced on them from the outside. Shareholders and boards of directors and managers and key employees have a network of contracts connecting them together. Their transactions costs are very low. Any disclosures that might be required for the benefit of shareholders can be determined

in the company's charter or by-laws or in its employment contracts. We do not need a statute to require disclosure to all and sundry.

When we come to insider trading, I have exactly the same reaction. No externalities are involved. For a company to legitimise insider trading, all it needs is a provision in its charter saying: "If you want to deal in the shares of our company, please understand that every key employee and every director is entitled to trade on inside information to their heart's content. If you want to invest with us, that is how it will be. If you do not want to invest with us, you are free to buy shares in our competitor, which does not allow that option".

What would happen if we legalised insider trading? We would discover a disinclination on the part of many firms to allow key people to trade on inside information. For example, firms are enormously sensitive about this topic when hiring lawyers for delicate corporate transactions. When a lawyer is working for a company about to enter into a major transaction, it is understood implicitly—and if necessary expressly—that information is made available only to allow the person to provide services to the company in evaluating the deal. The lawyer is not supposed to trade on that information, and most firms adopt very powerful prophylactic rules requiring some of their key partners to put their assets in blind trust, so as to avoid any appearance whatsoever of impropriety. In my own consulting practice, I have not traded shares of individual companies in years. I am terrified of the possibility of being accused of using inside information when I gave advice on major litigation or a transaction or a merger. If insider trading were permitted, there may well turn out to be similar self-imposed restrictions inside the firm.

On the other hand, allowing key employees to trade—perhaps only within limits—in inside information may in some circumstances be regarded as an effective compensation device. The question can be simply answered. If the value to shareholders of allowing insider trading is positive, we would expect to see companies putting relevant provisions in charters and employment contracts. They could realise a higher price for their shares if, rather than paying people in cash, they could more

efficiently compensate them by allowing them to profit privately from this type of information. If the value of allowing insider trading turned out not to be positive, we would expect to see the provisions running in the opposite direction. If some intermediate solution is preferred, that too would develop naturally, without government prodding. To the extent that we are dealing with the immediate parties to a transaction, no externalities cloud the analysis. We can let the market decide. There is no need for regulators to enter the picture at all, expect in the situations of concealment and fraud which I discussed earlier.

Disclosure of political donations

Finally we come to the question of disclosure of donations in the context of political elections. Here the picture is much more complicated, because there are externalities everywhere. A strong argument in favour of requiring disclosure is that anybody elected to political office will be beholden to supporters, and that those of us who are not in the ruling coterie are entitled to know what may influence the behaviour of those who take office. One response is to mandate the disclosure of any political contribution above a certain sum. But there is another side to this argument. Many people spend money on behalf of losing candidates. If such donors are required to publicly disclose their support, subsequently they may be singled out for retaliation. They have effectively made themselves sitting ducks. The difficult question is whether this useful information on donations, once disclosed, allows us to deal so much better with abuses of power that it outweighs the bad uses to which the information can also be put, if it falls into malevolent hands. I am myself unsure on this score. The answer may depend on the particular office for which people are running, along with the nature of the elections and a variety of other factors. The information dilemma is undoubtedly acute and very difficult to resolve.

Since the answer is indeterminate, we might fall back on presumptions. My own presumption is that, if there is no strong reason to impose a restriction, then the law should stay its hand. That presumption is

relevant to the disclosure issue, because the disclosure limitations themselves are extraordinarily expensive to impose. Once we have to disclose contributions, we need to say what counts as a contribution. Is it cash? Is it in kind? Is it services? How are they valued? If donations are made through an organisation, do we trace the individuals? It turns out to be a complex exercise. In addition, there are tactics other than legal remedies that might be brought to bear on this issue. We can ask a candidate repeatedly: "Did you receive money from Brown when you ran for office last time? If so, how much was it, and why did he give it?" If the candidate says "I'm not going to tell you because I have something to protect", voters can draw their own conclusions. Thus the ability to question individuals, and receive satisfactory or unsatisfactory responses, is arguably a quasi-market response which can be used. It is certainly not perfect. Public elections will inevitably involve external effects on disgruntled voters who voted for the opposition. We cannot use the same contractual logic that applies to securities and exchange transactions, where you are either dealing with shareholders or with outsiders who are aware of the terms of trade and can avoid taking part in the transaction if they so choose. With elections we have all the complicated problems mentioned by George Stigler in his original paper.

I will leave you with a final irony. In evaluating privacy statutes in the context of the classical common law approach, we find instances where contractual disclosure would be the norm and yet the statute prescribes a regime of unilateral confidentiality. On the other hand, in the area of executive compensation and insider trading, the contractual logic would lead us to non-disclosure as the norm, and yet there is now a statutory norm of disclosure. We appear to have gone backwards in both areas. All we need to do is disband both the office of the Privacy Commissioner and the Securities Commission. At that point we will have a more sensible answer to the question of when to disclose and when to keep things confidential.

Response by
Euan Abernethy
Chairman, Securities Commission

I WOULD LIKE TO PICK UP ON JUST ONE OR TWO POINTS. It is important to dispel any notion that there is intensive regulation of the securities market in New Zealand. Compared with overseas jurisdictions, New Zealand has very light-handed regulation, although in the view of some people there is still far too much. For instance, we do not have occupational licensing of securities dealers. We do not have official government surveillance of market participants. The Securities Commission has some enforcement powers, but they are very limited and relate only to the prevention of the dissemination of misinformation. There are some exceptions, such as occupational licensing for stockbrokers, but these are few.

The quid pro quo is a heavy reliance on the provision of information in the securities markets, which is one of the topics for discussion today. It is investor choice, based on that information, which drives the market. The regulator does not attempt to second-guess the decision of the investor: it is up to investors to decide on the level of risk they will accept. But it must be done on an informed basis, which is why we have the emphasis on disclosure.

On the question of the disclosure of executive remuneration, I fail to see why anyone should be too concerned. There are a number of other situations in which remuneration is disclosed because someone has a legitimate interest in receiving that information. For example the salaries of politicians are known because we have a legitimate interest in knowing how much we are paying them. Shareholders have a legitimate

interest in executive remuneration, because they want to know how well their board of directors is managing the company on their behalf. Directors are responsible for hiring and firing the chief executive and for setting his or her remuneration. These days, when there is a great deal of emphasis upon corporate governance, it is important for shareholders to know how well their board is performing. This includes assessing how much they are paying the chief executive in the light of the results of the company. Such knowledge is unlikely to result in a direct change to the chief executive's salary, but it may mean that some directors are removed. Thus I believe shareholders have a legitimate interest in that information.

As I understand Professor Epstein's argument, he suggests insider trading should be a matter to be determined between the parties. Inside information—that is, information belonging to the company—can be used for personal gain by executives or directors of the company if internal contracts so provide and this is known to people dealing with the company. I would rather look at it from a different point of view. I am interested in developing a vigorous and efficient securities market, which is a market where the expectations of the players in terms of information can be reasonably met. We will never get complete equality of information. But there is a legitimate community interest in promoting stable and efficient markets in which participants have confidence. If there are rules preventing the use of company information for private trading, those operating in the market will have more confidence, which will benefit the market as a whole. It might be argued that if the company agrees with the executives that they can use information privately, then that is not theft. But does that mean other market participants must search the company constitution before they buy and sell shares to discover what rules have been established? That seems to me to be imposing much more cost and effort on market participants than is desirable, and we should be striving for simpler arrangements.

Response by
Bruce Slane
Privacy Commissioner

I AGREE WITH MOST OF PROFESSOR EPSTEIN'S ANALYSIS, and in particular the inappropriateness in some cases of attempting to adapt property laws to issues of information. The New Zealand Privacy Act 1993, of course, is quite different from the counterpart American legislation, and is based on principles put forward by the OECD—an economic organisation. I should stress that privacy is not the same as confidentiality, nor is it the same as secrecy. This is relevant to what Professor Epstein has been saying, because he might well, for instance, reveal to somebody in New Zealand some piece of information that he has not revealed to anyone in the United States. While by doing so he may have broken secrecy, it is nonetheless a matter of privacy because he has chosen the person to whom he has disclosed that information. He has made that decision himself, and so privacy has been respected. I also agree with the comments made regarding the feasibility of a mixed regime: it is possible to disclose information to some people and not to others.

The New Zealand legislation favours openness. It tends to reinforce contracts that have been made: if a party promises that it will not disclose certain information, then the Privacy Act 1993 supports that decision. It enables companies to adopt their own policies on information concerning identifiable individuals, so long as they are open about those policies. Privacy Commissioners are engaged in a balancing act, because it is recognised that there are other issues besides privacy. This arises particularly in the case of freedom of information laws. Our Official Information Act 1982 has for some years had provisions about protecting privacy, but

they are not absolute; they require a balance to be maintained with other factors. Fortunately, New Zealand employers do not have the onerous obligations of US employers for the health costs of their employees. They are therefore not under the same pressure to engage in privacy-invasive practices such as random compulsory drug testing.'

On the question of executive remuneration, I am convinced as a result of my experience that New Zealanders believe details of their personal income warrant a high degree of privacy protection. Many individual executives have written to me expressing concerns about the impact on them personally of the forthcoming revelation of their income levels under the new provisions of the Companies Act 1993. Personal information will be made available at the expense of their privacy. While their concerns may not always attract great sympathy from the public, the high level of personal disquiet indicates a serious privacy concern rather than a desire to avoid accountability or to cover up.

In a recent case involving television, the Chief Justice drew the important distinction between those matters properly within the public interest, in the sense of being of legitimate concern to the public, and those that are merely interesting to the public on a human level. The issue is what is it that is actually in the public interest to be made known. I have come to the conclusion that the provisions of the Companies Act 1993 come under the heading of what is merely interesting to the public.

My conclusion is that the mandatory publication of executive remuneration is detrimental to individual privacy, and that a scheme could clearly be devised which better accords with privacy. I readily acknowledge that, if there is to be a change, there are other concerns—in which I am not involved—which may both support my view and militate against it. However, I have searched in vain to discover the greater accountability supposedly evident in the disclosure of these pieces of information in an unsystematic way, at arbitrary levels, without any details of job performance requirements, and in a context in which there is now a greater degree of performance assessment and review than was formerly the case.

In New Zealand, given the relatively small size of our companies, handing out information on incomes within $10,000 bands virtually identifies specific individuals, certainly in smaller companies. In some larger companies only one or two people will feature in some bands, and they will thus also be identified. I believe there needs to be a clear statement as to the government's objectives with this policy. It may well be that some different statistical information would be of more use to shareholders—such as the movement of salaries paid by the company in the relevant year, or the relationship of executive pay to some other important economic information being disclosed. I still do not understand the reason for requiring this disclosure in the form laid down, and believe accountability can be achieved without an invasion of privacy.

Discussion

Richard Epstein

Clearly there is disagreement between Bruce Slane and myself on the one hand, and Euan Abernethy on the other, over the disclosure of remuneration. It comes down to a question of how we assess 'legitimate interest'—a term used repeatedly by Mr Abernethy in arguing why the public, shareholders or prospective shareholders have a legitimate interest in disclosure.

The question is: what makes an interest legitimate? To me a legitimate interest is where the information will have positive value to the recipient if it is acquired, and where the recipient will be doing nothing improper or unlawful with the information. But we still have to face a hard question. The fact that information may be legitimately desired by another person is not in itself sufficient to mandate disclosure. We need to remember what the logic of exchange involves. An employee has a legitimate interest in his labour, and yet he surrenders it to the employer. The employer has a legitimate interest in her money, and yet she surrenders it to the employee in return for services. They do so on the basis that both sides stand to gain by the transaction. Similarly with information: in each and every case the logic of exchange does not call for the transfer of information simply because there is a legitimate interest in its receipt. It has to be shown that the value gained from the receipt of the information is greater than any loss on the other side. In the case of executive remuneration, we have heard from Mr Slane that, for a wide variety of reasons (many of which employees find it difficult to articulate),

the reluctance to have personal information revealed is very substantial. Most shareholders do not greatly care about this information. They find other ways to make directors accountable, such as examining bottom-line profitability. One of the reasons shareholders are opposed to public disclosure of this information is that of necessity it also goes to outsiders who could use it in ways which would be detrimental to their interests. That is why the public does not want the disclosure of key military intelligence even though it has a legitimate interest in knowing its contents.

In fact if we allowed insider trading, it would enable directors to disclose to shareholders and potential shareholders what they think to be of value inside a corporation, without making disclosures that would render the information valueless. There was a famous US case in 1968 involving Texas Gulf Sulphur. A company discovered some very valuable mineral deposits in northern Canada. Although it knew the location and may have had some options over the resource, it did not yet own the mining rights. The company was in a dilemma. If its officers wanted to trade, they would be obliged to disclose the information. They would have to say: "The reason we are buying shares is that we know there are some valuable mineral deposits somewhere in northern Canada, and the company is interested in acquiring rights to them". In that case many other parties would have rushed into the market in an attempt to acquire the rights. The disclosure would have resulted in a big loss of value to the company.

It is not trading that we want to discourage but corporate opportunism—the practice of using information received in the course of a company's business for private gain. If that is our focus, we would allow officers to trade in the shares of the company. The purchase of shares would be a sign of some unknown good news for the company, and yet it would not be necessary to disclose the nature of that information in a way that would disadvantage the company. The same principle works in reverse, for example when a company is faced with potential liabilities. When I have been retained by companies who are facing serious tort

actions, they have sometimes told me not to mention that I have been retained. They say to me, "It's simple. People know you are a torts expert. If they see we have retained you, it will be a sign that we are taking this case seriously. It may cause some shareholders to worry and offload their shares. We do not want to disclose the information, despite the fact that shareholders would regard it as material. On the contrary, it is so important to our shareholders not to disclose it that we will prohibit you from talking about it if you want to work for us". Such an understanding is perfectly appropriate, and they are entitled to expect me not to go out and sell the shares of the company on the basis of my confidential knowledge of their litigation.

To put it another way, there is no public interest involved in the abstract sense. The issue is one between shareholders. It is not a matter of telling them what is good for them, but of letting them decide for themselves. The procedures need not be onerous. If a company wants to permit insider trading in its shares, it need not hide the notice in a footnote of its charter. It can simply list the fact on the exchange. A single letter 'x' could designate companies in which the shares of the firm will be traded by insiders, while a 'y'—or simply the absence of an 'x'—could signify companies which do not permit such trades. Where firms want to engage in this activity, and are under an obligation to give notice to outsiders before they are allowed to do so, it would be very easy for them to signal their status to the market.

What about disclosure? This issue is a source of enormous difficulty. At least in the US context, nobody knows what the word 'materiality' means with respect to any given transaction. Volumes have been written about whether a piece of information is the sort that would be material to an investor of ordinary prudence and background. Companies spend thousands upon thousands of dollars trying to understand the disclosure rules, even when the information will not be relevant to transactions in which they are immediately involved. Not only must companies worry about insider trading—the dangers of which have been exaggerated—but they must also worry about misrepresentation and non-disclosure

regarding new issues and other corporate transactions, in ways that are a real impediment to business. That is the peculiar American genius—to take a simple idea and make it unbelievably complex. We get grotesque rules and an unworkable world—to parody the title of my own book.

I would prefer a world in which a company could say: "We are going to disclose some information. However, we will not disclose to you information that we know you will find material, but that we would find in good faith to be detrimental to our interests if it were allowed out". People can then decide for themselves whether they want to trade in the shares in that type of company. If an individual is worried about insider trading, he can follow one simple strategy: buy and hold. Every time the company's share price goes up, you take a free ride. If you are worried about insider trading that might harm your interests there are sophisticated responses. With the development of derivatives and other mechanisms, outsiders have more ability to work around these information problems.

On this score I would take issue on the analogy offered by Mr Abernethy. I see a powerful difference between these private situations and the obligations of public officials. Those officials work for all of us; we are all effectively their shareholders. We know that if relevant information is not disclosed, we may be left with some real questions as to what is going on. But in the case of the firm, there is no reason to treat the whole population of New Zealand or the United States as shareholders when most members of it have no direct interest in the firm. The question should be decided by shareholder democracy. And shareholders may well decide that the governmental analogy is not appropriate, if only because they can sell their shares if they do not like the firm's management, whereas it is rather more difficult to take similar action in the case of a government of which we disapprove.

I wonder if you are taking a rather narrow view of the relationship between shareholders and individual companies. Are there not ethical considerations that are overlooked when we allow officers of a company to trade in the company's own shares. In the marketplace, those who are implicated in any

way in insider trading are very loud in their protestations of innocence because of the ethical dimension.

Insider trading is taken very seriously, at least in the United States. Any executive charged with insider trading is facing criminal charges. If I were in the same position, I too would use ethical arguments to try to defeat criminal charges. Many defendants would say: "I think it is totally unethical for anybody to engage in this type of activity. You therefore know that I would never do it. You had better not throw me in jail, or sue me for $100 million dollars". How exactly the ethics would work out in a world without the present legal restrictions is a rather more complicated matter. People would no longer have the strategic advantage of appealing to ethical arguments as a way of defeating obligations.

My own instincts lead me not to be a great fan of insider trading as a form of compensation. If it were my corporation, I would be rather cautious, for the following reason. We generally want compensation to be correlated with the individual inputs a worker provides to the business. If a well-off employee, with plenty of cash and a risk neutral profile, had inside information about how hard her fellow employees were working, she could trade on that information and make a profit. Her financial gains would not be related to the labour she had contributed. Many corporations would probably install the other rule and ban insider trading. We can regard that as an ethical decision if we wish, because we are effectively saying that insider information has bad characteristics associated with it in that the value of the information possessed by insiders has no correlation with the value they add to the firm. In those cases, other forms of compensation more tailored to a person's actual contribution will be more appropriate. Most firms would probably not adopt the insider trading option. What will differ are the kinds of sanctions imposed for the violation of a company rule compared to the violation of an exchange rule.

As for having confidence in the market, that is as much a top priority for the individual company as it is for the exchange as a whole. American

CEOs seem to spend a great deal of time romancing analysts on the grounds that a bad word will erode the value of their stock in the market, and maybe their own employment. The private incentives are so strong that we do not need to worry about exchanges having to do the job.

Generally speaking, when I hear somebody talking about ethics without spelling out the particulars, I assume the person believes there is something incomplete about the analysis and I want to know what should be added in. The points that I have just made add two extra factors. One is the recognition of how people couch their arguments in responding to an unavoidable legal prohibition. The other is the economic argument that the right to trade on insider information may be an inefficient form of compensation, despite the fact that Henry Manne urged us to believe in its efficiency. Of course, in some firms it may be an inefficient form, but it may still be better than the next best alternative. It is far from clear that there is a uniform solution. Trying to impose uniformity gives us the one-size-fits-all problem which we always face with regulators. It is clear from the modern economic literature that questions concerning the distribution of holdings within a firm—whether there is a controlling block, whether institutions or individuals hold the shares, whether there is a transaction that is likely to be in play—may make a big difference in structuring the optimal firm-specific rule. These factors tend to be missed when we use legislation to create inflexible rules for shares traded on public exchanges. The sheer variability of business circumstances and the uniformity of regulation together create a problem which is endemic to the whole area of business regulation. It is not confined to rules on insider trading.

You referred to the possibility that disclosure of political donations would lead to the victimisation of those who fund the losers. Is it not implicit in what you said that you have assessed the potential harm from victimising those who fund the losing party as outweighing the potential harm of the favours granted to those who secretly fund the winning party? Can that be established?

Richard Epstein

I actually said that I was not sure on the answer to that question. But I did say that, in order to justify regulation, we would need to prove not only that the inequality runs the way you said it does, but also that the problem is large enough to justify the administrative cost necessary to rectify it. Let me give you another illustration where we have gone in the opposite direction on the issue of disclosure. John Stuart Mill was in favour of the open ballot. He believed that if somebody wanted to participate in an election, he should be required to announce to the world: "I am four square for White". Today secret ballots are regarded as an essential part of the democratic process, and for one reason—fear. The fear of retaliation is a very powerful factor. Some years ago in Chicago, for instance, an exit poll was conducted after an election to see whether or not the then Mayor Daley's favourite candidate would win. One of our local newscasters confidently predicted on the basis of the exit polls that the Daley candidate would be successful. It turned out that the candidate lost. Mike Royko—who is the wise old hand of Chicago journalism—was interviewed about the outcome and he said something like: "Don't believe the polls. There was a ward committee man standing within 10 feet of the pollster. Everybody knew that so they lied through their teeth and smiled to themselves as they did so, because they were afraid of retaliation if they let it be known they had voted for the opposing candidate". So fear is a very real issue.

Another example is the crisis of conscience at the University of Chicago over the Board of Trustee's decision to invest university funds in South Africa. This was to be put to a vote of all faculty members at a senate meeting. Every member of the protest contingent—without exception—demanded that there be a secret ballot. None of them wanted to be seen casting a vote against the administration—even if they doubted the likelihood of retaliation. Once we appreciate that retaliation can be a real factor in the case of a vote, it does not seem to me to be an idle threat with respect to campaign contributions. The issue is not decisive, but it is very relevant.

There is another element to consider—something that always strikes me when looking at information and the political process. The dangers of retaliation are directly proportionate to the amount of wealth that can be affected, in one way or another, by government action. One of the strongest arguments in favour of limited government is that the smaller the government, the less likely there will be retaliation because there will be fewer levers under its control. When I consult with large American businesses, I am always amazed at how timorous they are. I say to them: "Why don't you just tell the truth about this dumb regulator?" Their response often takes this form: "We don't just have one drug before the Food and Drug Administration for approval. We have a hundred. If we blow the whistle on one case we may pay the price on the other approvals. So we have to remain silent". In terms of day-to-day practice, wide discretion in the allocation of licences and privileges can make retaliation the order of the day. I have known powerful corporations which have been afraid to sue local governments for fear that their businesses will be closed down by a literal application of routine inspection laws to activities unrelated to the immediate controversy. And on the private side, the stories are legion of retaliatory evictions and retaliatory firings. We cannot escape this problem of retaliation in any setting, public or private. But we can try to limit its scope. Indeed one good reason for shrinking the size of government is to reduce the scope of potential retaliation in order to open up public discourse and dissent. The bigger the government, and the more multi-faceted its activities, the harder it is for any critic to evaluate the risk of going public with criticism. I am genuinely ambivalent about the answer to give to the question of political donations because the problem does not have a one-sided solution.