VOLUNTARY VS MANDATED DISCLOSURE

An Evaluation of the Basis for the Recommendations of the Working Group on Improved Investment Product and Adviser Disclosure

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PH.D., C.P.A.

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In addition to academic research, Professor Benston has consulted for and worked with the principal banking regulatory agencies in the United States (e.g. the Federal Deposit Insurance Corporation (FDIC), Federal Reserve, Comptroller of the Currency) and testified before several committees of the US Congress and regulatory bodies (e.g. the House and Senate Banking Committees, Securities and Exchange Commission, and the Financial Accounting Standards Board). Prior to entering academia, he was employed in public accounting and in banking.

PREFACE

This study focuses on the choice between voluntary and mandatory disclosure of information relating to investment products and investment advisers. This issue affects the efficiency of investment markets and hence the ability of people to save for retirement and other purposes. It was raised by the Task Force on Private Provision for Retirement 1992 (Todd Task Force) and is relevant to the design of the compulsory superannuation scheme that is to be the subject of a referendum in September 1997.

The Todd Task Force was concerned that information about savings products was not consistently available in a form that was clear, comprehensive and designed to enable prudent but non-expert savers to make meaningful comparisons among similar savings products. In its final report of December 1992, the Todd Task Force recommended that a specified minimum amount of information be made available to investors on financial products that are typically used by individuals for long-term savings purposes, such as interests in superannuation schemes, life insurance funds and unit trusts. The report also recommended that people who offer financial advice be required to disclose their qualifications, experience and financial interests in any investment products on which they advise. The Task Force recognised that its proposals would need to be the subject of more detailed consideration.

The recommendations of the Todd Task Force were examined by the Officials Group on Securities Law Reform. The Officials Group issued a consultative paper which contained the advice of an expert Panel (the Panel) in July 1993. The Panel proposed the mandatory disclosure of certain information in respect of all financial investment products, not just managed funds as proposed by the Todd Task Force. This approach greatly extended the scope of the proposal.

In August 1993, the Alliance, Labour and National parties reached an understanding on retirement income policy (the Accord). The Accord's provisions on disclosure requirements for private savings were limited. They provided that in respect of unit trusts, superannuation schemes, life insurance and other financial investment products offered to the public (referred to as savings products), legislation should be enacted to:

- provide for certain minimum disclosure requirements in respect of all savings products (both when an initial investment is to be made and on an annual basis thereafter);
- require cost-effective disclosure of information which meets the reasonable needs of a prudent but non-expert investor;
- facilitate comparisons among savings products; and

- require financial advisers to disclose their qualifications, experience, financial interests and procedures for handling client funds.

The Working Group on Improved Investment Product and Adviser Disclosure (the Working Group) was established in December 1993 to develop detailed recommendations to implement the Accord. The Working Group was asked to examine a specific proposal which went well beyond the provisions of the Accord. It was directed to report on whether a disclosure statement should be required to be supplied to investors in respect of all financial investment products offered to the public, whether a full prospectus should be required for superannuation, life insurance and unit trust products and whether investment advisers should be required to disclose information about their experience, qualifications, financial interests and procedures for handling client funds.

The Working Group released two consultative papers before presenting its final report in December 1995. (A slightly amended report was circulated in January 1996.) The Working Group's recommendations led to the adoption by the government of the proposals summarised below:

- a requirement to provide an investment statement to an investor before he or she subscribes to an offer to the public of:
    - - new equity;
    - - new debt (other than debt at call, a call building society share or a bonus bond);
    - - a new life insurance policy;
    - - a membership of a superannuation scheme (other than a small employer superannuation scheme);
    - - new participatory securities; and
    - - any new or existing interests in a unit trust.
- An investment statement is to provide all information, statements and other matters that it is required to contain by regulations;
- a requirement to register a prospectus in terms of the Securities Act 1978 for any offer to the public of:
    - - a new life insurance policy;
    - - a new interest in a superannuation scheme (other than a small employer superannuation scheme); and
    - - a new or an existing interest in a unit trust;
- a requirement for an overseas issuer of securities to provide investors with an investment statement even if the issuer is exempt from the requirement to register a prospectus in New Zealand;
- a requirement for issuers of securities to supply to an investor such documents and information of a kind prescribed in regulations. It is expected that this provision will require the supply of:
    - - a registered prospectus;
    - - the most recent annual report and audited financial statements of the issuer and/or the scheme;
    - - the related trust deed (or equivalent document); and
    - - certain information relating to any guarantee;
- a requirement for issuers of securities to supply to an investor, or prospective investor, who requests a copy of the registered prospectus:
    - - the registered prospectus; and
    - - any financial statements of the issuer or scheme that are referred to in the prospectus;
- a requirement for every investment adviser to disclose, before giving advice:
    - - the adviser's procedure for handling money or property; and
    - - if the adviser has been convicted of an offence against the Investment Advisers (Disclosure) Act 1996 or of a crime of dishonesty, or was a director or principal officer of a body corporate that committed such an offence, or has become bankrupt or been prohibited from taking part in the management of any company or business during the preceding five years, that fact;

- a requirement for every investment broker to disclose, before receiving investment money or property, similar information to that which is required to be disclosed by an investment adviser;
- a requirement for investment advisers to disclose on request from any client:
  - - certain information about the organisation with which the adviser has a relationship; and
  - - the types of securities about which advice is given, the adviser's qualifications and experience to give advice, and certain information relating to the adviser's pecuniary or other interest related to the advice tendered;
- the replacement of a requirement to provide prospectuses relating to new issues of equity, debt and certain other securities to prospective investors with an obligation to supply them on request;
- the extension of the life of prospectuses, provided that certain conditions are met, and the introduction of a provision which allows a prospectus to be combined with an annual report;
- the abolition of a requirement that financial statements which are registered under the Financial Reporting Act 1993 are to be included in a prospectus but their registration under that Act is to be referred to in the prospectus; and
- the exemption of registered banks from the requirement to register a prospectus in respect of debt securities offered to the public. Registered banks are, however, required to disclose certain information in terms of prudential supervision arrangements that were introduced in January 1996.

These proposals were enacted by amendments to the Financial Reporting Act 1993, Securities Act 1978, Superannuation Schemes Act 1989 and Unit Trusts Act 1960, and by the Investment Advisers (Disclosure) Act 1996. They are expected to come into force in October 1997.

The New Zealand Business Roundtable's submissions on the consultative papers and the draft legislation had a common theme: that a compelling case for an expansion of mandatory disclosure of information in respect of financial investments had not been made by the Todd Task Force, the Panel's report, the Working Group's 1994 and 1995 consultative papers and its final report, or by any other organisation. The Working Group reported that a first principles analysis of disclosure requirements was beyond its terms of reference (see page 114 of the Working Group's final report). Instead the Working Group took the Securities Act 1978 as a given and sought to achieve a degree of conformity among securities within the framework of that Act. In the New Zealand Business Roundtable's view, this approach did not meet recognised standards of economic analysis for determining whether government action is justified.

The Securities Act 1978, and the Securities Commission's 1980 report on which the Working Group drew, reflect an economic approach which is inconsistent with contemporary financial economics thinking, in particular on the importance of transaction costs, including information costs, and research since the mid-1960s which has cast doubts on the merits of much public regulation of the securities market. At a practical level, a precise statement of alleged mischiefs, an evaluation of their frequency and seriousness, a careful analysis of the inadequacies of present law and enforcement in addressing them, and an assessment of the extent to which the proposals will remedy any shortcomings cannot be found in any reports and consultative papers that were produced.

Believing that an unsatisfactory approach had been taken to an important public policy issue, the New Zealand Business Roundtable decided to commission an independent review of the proposals. Its terms of reference focused on the choice between mandatory and voluntary disclosure because that is the fundamental matter on which the recommendations of the Working Group and the New Zealand Business Roundtable disagree. The choice relates to the disclosure of particular financial information where general sanctions against fraud, misrepresentation and breaches of fiduciary responsibility apply, and lawful contracts are upheld. The analysis presented in the Working Group's final report, rather than the detailed legislative provisions, is examined, as it is the principles that should inform public policy that are in question.

Following an approach by the New Zealand Business Roundtable, Professor George J. Benston, a distinguished academic and finance specialist, agreed to undertake the review. Professor Benston is the John H. Harland Professor of Finance, Accounting and Economics at the Goizueta Business School and Professor of Economics in the College of Arts and Sciences, Emory University, Atlanta. He has published extensively on financial disclosure, accounting standards and regulatory issues.

Professor Benston concludes that:

. . . although many of the Working Group's disclosure recommendations seem to be innocuous and of potential value to investors, there is reason to doubt their usefulness to investors. Certainly, there is no reason to believe that any uniform set of mandated disclosures can be effective for all investments and all investors. Consequently, the costs of mandated disclosure are likely to exceed the benefits to investors, thereby discouraging rather than encouraging people to save for retirement.

Fortunately, there is an alternative - voluntary disclosure driven by market forces. Competition among investment providers should be effective in giving investors the information they need and for which they are willing to pay. . . .

Finally, it should be recognised that the people of New Zealand have, or could have, a wide choice of investments that offer varying degrees of information. They can purchase securities offered by firms that are subject to US, UK, Australian, Japanese, Singaporean and other countries' laws and regulations if they want the 'protection' and cost of these laws and regulations. Consequently, New Zealand should consider eliminating all but basic disclosure requirements on its companies. . . . New Zealand law would still protect investors from fraud and misrepresentation. Giving New Zealand savers and companies more choice is, I suggest, the best way of achieving the mandate given to the Working Group - promoting the efficient allocation of the country's resources and enhancing peoples' willingness and ability to save.

Professor Benston's review suggests that the legislation that arose from the Working Group's report was poorly conceived. Savers will face higher costs and will be denied investment opportunities that would otherwise be available. The New Zealand Business Roundtable believes that the legislation should be reconsidered in the process of designing the compulsory superannuation scheme which is to be put to a referendum in September 1997. A first principles examination of the Securities Act 1998, which incorporates the analysis presented by Professor Benston, should also be undertaken.

R L Kerr

Executive Director

New Zealand Business Roundtable

EXECUTIVE SUMMARY

The Working Group's Recommendations

Through its 'Recommendations', the Working Group seeks to have government enact laws and agencies develop rules that would encourage people to "save for their retirement through appropriate savings products". The Working Group has put forth several important basic principles worth repeating:

- ordinary consumers should make informed choices and product providers and advisers should deliver high quality, innovative services that meet consumers' needs;
- the law's purpose is not to reduce business risks, or to insulate market participants from poor business judgments - therefore, merit legislation is rejected; and
- disclosure requirements should be cost effective.

Shortcomings of the Recommendations

Unfortunately, many of the Recommendations, if adopted, are likely to reduce people's incentives to save and are inconsistent with the laudable basic principles enunciated by the Working Group. Specifically, contrary to the Working Group's expectations:

- rules governing disclosure should not be required to be neutral and equivalent;
- there should be no required minimum disclosure of information to buyers of unit trusts, life insurance, superannuation and other financial products; and

- investment advisers should not be required to disclose additional detailed information about themselves.

Although neutrality, equivalence, and minimum uniform disclosure appear to be innocuous requirements, when the same disclosure rules are specified for different investments the result is likely to be both overly costly and misleading information, unless the kinds of investments offered to consumers are severely limited. But this limitation would be contrary to the Working Group's correct prescription that consumers be offered a wide range of products. The problem is that uniform and prescribed disclosure rules, almost by definition, are not appropriate for meaningfully informing consumers about diverse financial products. As is explained in the paper, the diverse products should be evaluated with quite different information, and the gains and shortcomings of the products depend on the situations faced by individual consumers. Consequently, adoption of the Working Group's proposals would reduce the benefits to consumers from saving.

Investment advisers presently are subject to legal fiduciary responsibilities towards investors; additional requirements would simply add to their costs and, hence, reduce the availability of their services or the costs to investors of using their services.

The Impossibility of Mandating Useful Disclosure and the Benefits of Voluntary Disclosure

Most importantly, the Working Group does not appear to appreciate the virtual impossibility of a government agency determining, with any meaningful degree of specificity, the information that individual investors would need to make informed decisions about different investment products. From a consideration of these requirements, it seems clear that disclosure by a government agency or by legislation is likely, at best, to be incomplete or useless, and might be misleading.

At the same time, the Working Group fails to appreciate the benefits of voluntary disclosure. Product providers have both the incentives and means to determine the information that prospective customers for their products might find useful. Importantly, less affluent and inexpert investors, for whom the costs of processing detailed information probably exceed the benefits therefrom, can 'free ride' on the efficiency with which the prices for publicly traded obligations reflect information. Scores of empirical studies using data from several countries attest to the fact that stock markets are efficient and that, once information becomes public, there is little, if anything, that investors can learn about a company that is not already reflected in its stock price. Furthermore, empirical studies of US stock markets have shown that prior to enactment of government-required disclosure in 1933 and 1934, voluntary disclosure was commonplace among publicly owned companies. Studies of later data find that required disclosure adds little to what appears already to be known to investors.

Incentives of Product Providers

In considering voluntary disclosure, it is important to recognise that product providers, rather than consumers, bear the cost of insufficient information. For, if consumers cannot readily evaluate a product, it is worth less to them. Hence, the product will have to sell at a lower price to compete with an alternative that can be more cheaply analysed. Furthermore, competition among product providers makes it likely that consumers will be apprised of alternatives.

Product providers with inferior products, though, might be tempted to mislead or fail to inform investors about their products' shortcomings. However, such actions are illegal under New Zealand law - new legislation is not required. In addition, competitors can gain from pointing out the shortcomings of such products. Perhaps most important, though, is the role of the product provider's reputation. Those who intend to remain in business have a strong interest in establishing a good reputation for probity, service, and expertise, particularly in a small country such as New Zealand.

It might be argued that mandated disclosure is necessary to bring forth information that could be used by all investors (an externality). However, product providers already have incentives to provide information to potential investors, information services already gather and publish such information, and (as noted earlier) there is no reason to believe that government-mandated disclosure would provide additionally useful information to investors.

The Cost to Investors of Government-Mandated Disclosure

In addition to being close to useless, government-mandated disclosure is likely to be very costly to investors. Direct costs incurred by companies to produce and publish the data are actually borne by investors. From the experience of other countries that have mandated financial disclosure (notably, the United States), requirements become more and more detailed and costly to fulfil. Despite these very high costs, there is no evidence that the US securities market has become more efficient or that it is more efficient than markets in countries with fewer disclosure requirements. Importantly, non-expert investors, particularly, might be misled into believing that the information they are given necessarily is adequate because it is government-mandated. Rather, investors are well advised to exercise due diligence about the products or to investigate the reputations of those who would sell them financial products.

Conclusions

I conclude, therefore, that voluntary disclosure is far superior to government-mandated disclosure, as the costs of mandated disclosure appear much greater than the benefits to investors. The choice of what information is worthwhile should be determined by New Zealand investors. New Zealand companies should have few requirements imposed on them. These companies (which are and should continue to be subject to anti-fraud and anti-misrepresentation laws) would then have strong incentives to offer investors the information that they want and are willing to pay for. To the extent that they do not, New Zealand investors can choose investment products offered by overseas companies resident in countries which require varying degrees of disclosure.

INTRODUCTION

The Working Group's recommendations, as presented in *Recommendations for Improved Investment Product and Investment Advisor Disclosure, Final Report* (21 December 1995, corrected 25 January 1996) are delineated in Chapter One of this report. Following each of the important points on which the recommendations are based, I give brief assessments. Overall, I find that the Working Group has overlooked the role of and benefits from voluntary disclosure. The bases for this conclusion and for the assessments given in Chapter One are presented in Chapter Two under the title, 'The Philosophy of Voluntary Disclosure'. Two questions are asked and answered: 'What information do investors need to make informed investment choices?' and 'What reason is there to believe that product providers and advisers would not voluntarily provide investors with this information?' Chapter Three considers 'The Costs to Investors of Mandatory Disclosure'. A brief conclusion follows.

CHAPTER ONE

FOUNDATIONS AND ASSUMPTIONS ON WHICH THE WORKING GROUP'S RECOMMENDATIONS ARE BASED

To provide an overview of the foundations and assumptions on which the Working Group's recommendations are based and my criticisms of them, I quote and identify with the following margin marks: " " the items presented in Part IV ('Policy Framework') that are important and about which I believe the Working Group is mistaken; brief assessments of the items are given in square brackets. The reasoning and evidence on which these assessments are based is presented thereafter.

The Working Group's recommendations are designed to support "two sets of wider objectives . . . one related to securing the Accord [Part 4]; the other related to securities markets in general" (para 74). Part 4 of the Accord would be supported by presumably improved disclosure which, the Report (para 74.a) asserts, "is part of an overall strategy aimed at empowering ordinary consumers to:

"i Make more informed investment choices;

[If by "more informed choices" the Working Group means that the benefits to investors of more information should exceed the costs to them and to product providers (who, necessarily, will pass on the costs they incur to investors) of providing and using the information, I agree. However, there is reason to expect that much of the information that the Working Group would require product providers to assemble and disclose will not be cost effective and, hence, will not benefit investors.] and

"ii Put more pressure on product providers and advisers to deliver higher quality, more innovative services that better meet the needs of ordinary consumers."

[There is little reason to believe that the mandatory disclosure recommendations will achieve this desirable goal or that it would not be and is not presently provided by competition among product providers and advisers.]

- With respect to the securities market in general, the Working Group accepts "two main policy objectives in regulating securities markets" (para 74.b):

"i To promote an efficient allocation of resources; and

"ii To provide for effective enforcement against dishonest and unfair conduct."

[These are indeed laudable goals.]

The first point is elaborated as follows (para 76):

"In the Working Group's view, high quality allocation of capital is driven mainly by robust rivalry between product providers seeking to raise capital from well informed market participants. By definition, investment decisions involve risk and judgment, for product providers and investors. The law's purpose is not to reduce business risks, or to insulate market participants from poor business judgments. To do so would impair the quality of investment decisions over time and reduce innovation by product providers."

- [This is an excellent description of how markets work and should be permitted to work for the benefit of consumers and the economy generally.]

The Working Group specifies and describes (para 78) four "mechanisms for achieving objectives" or "policy principles to the Accord Parties' instructions to develop statutory minimum disclosure requirements for 'prudent but non-expert investors':

"a *Disclosure philosophy*:

- "The policy focus is on providing investors with sufficient information to enable them to make their own decisions. Merit regulation . . . has been rejected.
- [This is an excellent philosophy. The key issue, however, is whether it is necessary, desirable, or even possible for a legislature or government agency to determine which specific information will be "sufficient to enable [investors] to make their own decisions". Both theory and evidence indicates that mandating information is not necessary, because the issuers of investments (and investors) have strong incentives to assess which information investors might want and the form that it should take. Mandated disclosure is not desirable because it is unlikely to be cost-effective and, hence, will discourage investment. It should also be noted that it is not physically possible for relevant information to be disclosed to all investors in publicly traded securities in a timely manner. Finally, for many investors the cost of using all the information that would enable them to make their own decisions exceeds the gain from this exercise. These investors are likely to benefit from simply investigating the skill and probity of an intermediary in whom or through whom they invest.]

"b *Cover public offerings:*

- " . . . the disclosure requirements should cover all securities offered to the public.
- [Although this seems reasonable, except for some very general requirements - such as the name and address of the offerer - the information that would be useful to investors differs considerably among different investments. It is not possible to pre-specify information that describes adequately the important features of all publicly offered investments.]

"c *Rules to be neutral and equivalent:*

- ". . . across that range of securities. In particular, it is important to avoid regulatory distortions that arise from differential disclosure requirements which lack a coherent rationale.
- [A desirable objective, unless distortions result when the same requirements are specified for different investments, resulting in the production of either overly costly or misleading information; such would be the situation were many of the Working Group's recommendations adopted.]

"i . . . merit regulation . . . has been rejected; and

"ii It is not possible to differentiate securities at law based on the investor's presumed intention in buying or selling a security."

- [These are important and valid assumptions; 'merit' legislation has almost always been costly to investors and to the economic health of a nation.]

"d *Rules to be cost-effective:*

- "The proposed disclosure requirements should achieve the Accord Parties' policy objectives in a cost-effective manner."
- [It is, indeed, important for rules to be cost-effective. And, people would be encouraged to save for retirement if it were less costly for them to decide among alternative investments. However, many of the Working Group's proposals are likely to be cost-ineffective and, consequently, would discourage people from saving to the extent that these higher costs reduce the returns that they can obtain from their savings.]
- The relevant policy objective (para 25 c) appears to be: "People should be encouraged to save for their retirement through appropriate savings products, supported by education and the provision of information about retirement matters . . . ."
- The connection between this objective and the Working Group's proposals seems to be the following further proviso (para 25 j): "To provide a more certain environment for people to save for their retirement, legislation should be introduced to require:

"i a minimum disclosure of information to buyers of unit trusts, life insurance, superannuation schemes and other financial products offered to the public (*Accord, clause 4.1*);

[The information that investors might want for choosing among investments in equities, debt instruments, unit trusts, life insurance, superannuation schemes, and other financial products differs considerably, so much so that it is not feasible nor would it be desirable to specify the same disclosure requirements for them all.]

"ii and investment advisers to disclose their qualifications, experience, financial interests and procedures for handling client funds (*Accord, clause 4.2*)."

[Investment advisers presently are subject to laws dealing with their fiduciary responsibilities towards investors; these additional requirements appear to add little but additional costs that, ultimately, would be borne by investors.]

CHAPTER TWO

THE PHILOSOPHY OF VOLUNTARY DISCLOSURE

Referencing the Securities Commission's 1980 Report, the Working Group (para 81) describes the "debate on the relative merits of disclosure" as between (a) the "publicists", who would require disclosure and permit investors to make their own decisions and (b) the "sceptics", who would have government agents determine which investments should be offered to the public. As noted above, the Working Group rejects merit legislation and, hence, rejects (b). If the choice were between mandated disclosure and merit legislation, I am certain that most, if not all, financial economists would favour mandated disclosure. However, the Working Group does not consider a third choice, voluntary disclosure. This approach permits market forces to determine what is disclosed to investors.

Voluntary and mandatory disclosure can be usefully contrasted and evaluated by posing and answering questions based on the basic features that the Working Group delineates as necessary or desirable to fulfil the public saving objective of the *Accord* (as outlined above):

- 1 What information do investors need to make informed investment choices? Is this information the same for equities, debt, life insurance, unit trusts, and superannuation?
    - 1.1 What are the comparative advantages of product providers over mandatory disclosure, including government commissions (such as the Working Group), regulators (e.g. employees of the Securities Commission), and legislators, in determining what information is material and relevant to potential investors, not only at a particular time but over time as conditions change?
    - 1.2 In public markets (such as the securities market), can non-expert investors 'free ride' on the decisions made by better informed, more expert investors and their advisers? If so, non-expert investors would not benefit from mandated information. (This understanding appears to be the basis for the Working Group's proposal - requiring that only a relatively simple investment statement be given to non-expert investors and a detailed prospectus be available on request, presumably for expert investors.)
- 2 What reason is there to believe that product providers and advisers would not voluntarily provide investors with this information?
    - 2.1 What incentives do product providers have to voluntarily provide or deny relevant information to potential investors?
    - 2.2 What is the role of the reputation of the investment issuer and independent information services for protecting non-expert investors and reducing their information cost?
    - 2.3 Are the incentives for the voluntary production of information sufficient, considering that there may be benefits that cannot be captured by providers individually (externalities)?

2.1 Information Needed by Investors to Make Informed Investment Choices

An investor clearly is interested in the return on and risk of an investment - the amounts and timing of net cash flows (or their equivalents) that the investment is expected to generate and the probability that these amounts and timing will be other than promised or expected. The following very brief review of some information that investors might want in order to determine or predict the returns and risks on various investments should show how difficult it is for anyone to know what information should be provided to investors.

Returns are measured by the change in value of an enterprise on which the investor has a claim. The change in value is determined by the cash flows or their equivalents generated from the assets employed by that enterprise. The times at which these cash flows become the property of the enterprise is important, because of the time value or opportunity cost of delay. Cash flows can be invested at an appropriate discount rate; the later that cash is obtained and the greater the risk that it might not be forthcoming as expected, the less is its value. Consequently, the value of the enterprise is measured as the discounted or present value of expected net cash flows. Because the purchasing power of the monetary unit (dollar, pound, etc.) changes, the cash flows or the discount rate must be adjusted to account for these changes. Thus, at a minimum, to determine expected returns investors must estimate future cash flows, their timing, changes in purchasing power, and the appropriate discount rate.

In particular, the investor who wants to estimate the returns on investments must understand the operations of the enterprise in which the investments are made, its competitive environment, changes in technology that might occur and how they affect the enterprise and its competitors, the cash flows that will be generated from the enterprise's assets and what proportion will be paid on its contractual obligations, the expected change in purchasing power, changes in consumers' tastes, preferences, opportunities, and budgets, and many other variables. Furthermore, the economic situation of enterprises changes as these and other variables change. Consequently, an estimate of return made as of a particular date is likely to be inaccurate very quickly. Once the effect of these and other variables on the enterprise is taken into account, investors must determine what portion of the value of the enterprise will accrue to or be distributed to them and the probability that the promises made to them will be fulfilled.

Investors are also interested in risk, two aspects of which should be delineated. One is the reduction in the amounts of promised returns that can be predicted. The probability that the promised payments (e.g. from a bond or loan) will be paid as promised can be multiplied against those amounts to determine expected cash flows. For example, a $10,000 loan might promise $1,200 annually (12%), but there is only a 60% probability that it will be paid, a 20% probability that $1,000 will be paid, a 15% probability that $800 will be paid and a 5% probability that nothing will be paid. Then, the expected payment is $1,040 ($1,200 x .6 = $720; + $1,000 x .2 = $200; + $800 x .15 = $120). Risk for that year is $160 ($1,200 - 1,040) and the expected return adjusted for the risk of non-payment is 10.4%.

The other aspect of risk is uncertainty, the variance of returns that are expected. For example, a $10,000 government note might promise a return of 10.4%. Investors who do not care about the uncertainty with which the promised payments might be made should be indifferent between the 10.4% expected (12.0% nominal) loan and a 10.4% government note. However, if investors find the uncertainty of cash flows from such loans to be undesirable, they would have to be paid a risk premium to accept the loan rather than the government bond.

In addition, investors should be influenced by the relationship between the returns and risk of specific investments with the returns and risk of their other assets and liabilities, human as well as monetary and material. As finance theory has established, the measurement of uncertainty requires estimation of the simultaneous net cash flows (covariance of returns) from all sources. Thus, an individual investor should combine the expected net cash flows from investments in equities, unit trusts, debt instruments, bank accounts, real estate (including an occupied home), superannuation (private and government), and so forth with cash flows from employment, gifts, and other sources. All of these cash flows should be estimated net of tax. Reliable estimates of the timing of the net cash flows and the opportunity cost of not investing in the next best alternative (the cost of capital or discount rate) are necessary for investors to determine the benefits from making a particular investment.

Furthermore, the information required for specific investments is not the same for all investments individually or by type, contrary to the assumption underlying the Working Group's recommendation for uniform mandatory disclosure. The following brief descriptions of *some* of the information that could and should reasonably affect investors' decisions show, I believe, that a governmentally imposed prescription of minimum disclosure will be either insufficient or excessively great, even assuming that the specific items mandated were meaningful or reasonably sufficient for all or even many investors:

- Investments in *equities* promise only the possibility of returns. Returns on equities depend on the productivity of assets employed in the enterprise and the obligations assumed by the enterprise. These, in turn, depend on the ability and probity of the enterprise's managers, the incentives of the firm's managers to operate the firm in the interests of the shareholders, the efficiency of its other employees, the effectiveness of its competition, government actions, general and specific economic conditions, luck, and other factors. Few, if any, of these factors are stable. The uncertainty of their effect on the enterprise gives rise, in part, to the risk involved from an investment in it.
- Investments in *debt* often are easier to evaluate. Unlike equity, which promises residual returns, debt has an earlier claim on the resources of an enterprise. Hence, the returns and risk are easier to estimate. However, the contractual obligation on which debt claims are based may have clauses that weaken

these claims under some conditions. Furthermore, the cost of enforcing the contracts may make the claims worth relatively little, should the enterprise get into financial difficulties.

- Investments in *life insurance* (other than the term-insurance aspects) depend on the investments made by the insurance company from which the projected returns will be paid to the investor. In some countries (e.g. the United States) the returns on insurance policy investments are not taxed to the insured person, which increases the value of this investment vehicle to high-tax-bracket people. In New Zealand, investment income is taxed when it is earned by the insurance company at a rate equivalent to the top personal tax rate; hence, lower-tax-bracket people are disadvantaged. Consequently, it is important for investors to consider their present and future tax brackets and possible changes in the tax law over the time that is relevant to them.
- Investments in *unit trusts* can be materially affected by the securities held by trusts, changes in the trusts' investments, the extent to which trusts trade securities, trusts' other operating expenses, and, importantly, the economic conditions that beset the investments made by trusts. The past returns on unit trust investments can be measured relatively easily, if one specifies the period over which the returns are assumed to have been earned. However, acknowledged experts disagree strongly on how the past risk of investments in unit trusts should be measured. In the United States, the Securities and Exchange Commission has not been able to decide on the appropriate measure. In 1996 the Financial Economists Roundtable (a group of well-published academics) debated this issue; two Nobel Prize members, William Sharpe and Franco Modigliani, championed different measures. One such measure would compare the variance of daily returns on the unit trust with the variance of returns on indices of stocks (such as low-capitalisation stocks, utilities, high tech companies, and so forth) that mirror the trust's investments, weighted by the proportion of shares in each group. Which indices are comparable and how the weights should be calculated are not obvious. Another measure would compare the returns of the unit trust and their variance with those of a market-wide index, based on the assumption that this is the alternative investment that investors might make. Furthermore, investors should be interested primarily in the returns and risk expected over the period that they expect to hold the unit trust. It is less clear how these should or even can be measured.
- Payments from *superannuation* schemes depend on the investments made by the providers (equities, debt, real estate, and so forth), their operating costs, and the tax status of the contributor. Because investments in superannuation schemes are designed to provide future income to the investor over a relatively long period, evaluations of the stability of the provider and its future as well as present investment policies, internal controls, and probity are all important.

2.1.1 The Comparative Advantage of Product Providers Over Mandatory Standard Setters

The plethora of information required for investment choices, the specificity with which this information should be used both with respect to individual enterprises and to different kinds of investments in these enterprises, the probability that the data will change over time, and the relationship of the returns and risks of specific investments to the wealth, prospects, and requirements of individual investors make it difficult to understand how information could be pre-specified. Hence, it seems clear that disclosure mandated by a government agency or by legislation is likely, at best, to be incomplete or useless, and might be misleading. Furthermore, mandated disclosure cannot be tailored to meet the needs of individual investors.

In contrast, product providers who expect to be successful generally must know their customers' situations in order to sell them particular investment products. As is the case for anyone selling anything, product providers must either tailor their products to the perceived needs of potential customers, inform those customers about the attributes of the products and how and to what extent these attributes meet the customers' demands, or alter the product to meet customers' demands.

Furthermore, each customer's needs and situation are likely to follow different time patterns. Younger investors may be willing to accept greater risk in exchange for a greater return. Older investors may want greater certainty. Investors whose requirements for funds vary might want lower transactions costs. The tax situation facing investors varies. People with secure jobs may be willing to take greater risks than those whose employment prospects are uncertain. In addition, as investment opportunities, tax laws, the effect on investors' wealth of past investment and other decisions, investors' health and employment prospects change, and so forth, their preferred investment portfolios change.

Of course, it is rarely cost-effective for product providers to learn and deal with all of the variables that are relevant for each individual investor. Depending on the costs of obtaining and using the information, efficiencies may be obtained from simplifying assumptions, putting investors into groups of similarly situated people, standardised products, and the like. These 'shortcuts' are likely to be much more exact and useful than any set of rules devised by a law or government agency and mandated for all investors and all investment products.

2.1.2 Information in Public Markets - 'Free Riding' by Non-expert Investors

Non-expert investors, with whom the Working Group is particularly concerned, suffer important disadvantages in obtaining and using information that is relevant for many investment decisions. As neophytes, they would have to invest in a substantial amount of education to determine the specific information they might want and then to learn how to use it effectively. Non-expert investors are also likely to be interested in relatively small placements. In contrast, expert investors and their agents usually deal in large quantities. Consequently, they are often willing to incur costs so as to benefit from obtaining and using information to buy or sell investments quickly, before other investors learn of increases or decreases in the investments' values. Their trades determine the market price. Hence, non-expert investors are unlikely to benefit from learning how to use and from using disclosed information.

Fortunately, the prices of publicly traded investments tend to impound (discount) very quickly the present value of all but privately held (inside) information. The validity of this statement has been very extensively supported in hundreds of research studies, particularly with respect to traded securities. These are generally called 'event studies' because they examine the change in stock-price returns associated with an event. (For example, the first paper to use this technique examined the effect on stock prices of announcements of stock splits.) The change in stock prices that usually accompanies a change in an index of market and (in some studies) industry stock prices are usually accounted for (with 'beta' coefficients) and attempts are made to measure that aspect of the event that was expected by the market (hence the announcement of the event rather than the event itself tends to be examined). The events studied include announcements of mergers and acquisitions, equity carve outs, split offs of subsidiaries and divisions of corporations, dividend changes, changes in exchange listings, the unexpected death of a chief executive officer, actions taken by government regulatory and antitrust agencies, and private law suit filings.[1] Almost all of these studies lead to the conclusion that, once information becomes public, there is little, if anything, that investors can learn about a company that is not already reflected in its stock price. Consequently, it does not appear that even sophisticated investors can gain much from using information more than a few days (if that) after it is released.

Most of the empirical event studies group corporations into portfolios that are affected by similar events (such as a merger announcement). Within the portfolios there is considerable variance in the stock-price reactions, even to very important events. For example, although on average stock prices increase when a company announces that it might be acquired, the reaction is not always significantly different from zero or even positive. With respect to more usual events, such as the announcement of an unexpected increase in dividends, although the stock-price reaction for a portfolio tends to be statistically significant in the expected direction, it is quite diverse for individual stocks; indeed, it is often perverse for a substantial proportion of individual securities. Hence, unless the investor can purchase a portfolio of stocks and benefit from the average return, prediction of changes in the prices of individual stocks is very uncertain, even when the investor gets the information before it is announced to the market.

Of particular interest for the Working Group's disclosure proposals are the hundreds of event studies that examined the extent to which announcements or publications of financial accounting data are related to changes in the prices of those companies' stock-market-traded securities.[2] Most of these studies examine announcements of net earnings, generally in portfolios. In addition, the studies have examined individual items above the 'bottom line', including extraordinary and special items, sales, and earnings stated in terms of cash flows. Voluntary changes in accounting for inventories, depreciation, the investment tax credit, pensions and leases have been examined. Changes required by the Securities and Exchange Commission, the Financial Accounting Standards Board (and its predecessors), and government banking agencies have been studied, including replacement costs of assets, price level adjusted data, oil and gas exploration expenditures, lease capitalisation, pension liabilities, research and development, foreign currency translations, accounting by lines of business, use of generally accepted accounting standards by banks, statements of securities at market values, and disclosure of fully diluted earnings per share. Reports of auditors' qualifications, changes in auditors, upward revaluations of assets (in Australia), and social responsibility activities have also been studied. These studies have been conducted primarily on US data, but some also use data from Australia, the United Kingdom, France, Germany, Sweden, and Japan.

In general, the accounting event studies are consistent with other event studies. The accounting studies find that stock prices very quickly (within a day) reflect the information content of the information disclosed. The stock price reaction to earnings announcements, though, is relatively small, even when stocks are grouped into portfolios. When individual stocks are studied, the amount of variance of the stock price changes explained is very small - generally 2-5% (Lev, 1989, p.163). Thus, there is reason to question whether even expert investors can efficiently use disclosed accounting information - that is, whether the costs of obtaining, analysing and using the information are less than the gains from trading based on the information.

While the empirical studies indicate that non-expert investors cannot efficiently use disclosed information on traded securities to make investment decisions, these investors can efficiently purchase portfolios of securities by investing in unit trusts. Although there is reason to question whether unit trust managers can use information efficiently, non-expert investors can benefit from diversification and, hence, from reductions in uncertainty.

2.2 Voluntary Provision of Information by Product Providers to Investors

Although empirical studies find that accounting information is of little value to investors in traded securities at the time it is disclosed, there is evidence that these data are valued by investors. An important and telling fact is that financial accounting statements were offered to investors long before they were required by law. In the United States, prior to passage of the Securities and Exchange Act of 1934 which first required disclosure, all corporations with stock listed on the major exchange (the New York Stock Exchange, NYSE) provided fairly complete financial statements to investors and all but one company was audited by certified public accountants (Benston, 1973). Sales, the single most important item not reported by 38% of NYSE corporations prior to passage of the Act, had to be disclosed after 1934. An analysis found that required disclosure of sales had no measurable effect on stock prices (adjusted for general market changes), indicating either that investors had learned about sales from other sources or that they did not find the information of much benefit in valuing the shares of the corporations that previously did not disclose sales (Benston, 1973).[3]

2.2.1 Incentives for Product Providers to Provide Information Voluntarily to Investors

Three aspects of the incentives of product providers are particularly important: (a) product providers bear the cost of under-informing investors; (b) competition among product providers ensures the optimal production and distribution of information (with an important exception, discussed in section 2.3); and (c) some product providers have incentives to misinform or under-inform investors.

(a) The cost of not adequately informing investors is borne by product providers

Similar to sellers of any good or service, product providers realise that consumers of their products (investors) benefit from expected returns net of the cost to the investors of learning about and deciding to purchase the investment. Furthermore, if investors are averse to uncertainty (risk), they will expend resources to determine the extent to which returns on investment products are uncertain. The cost to consumers of the information reduces the value of investments to them. (Indeed, a reduction of these costs appears to be an important motivation for the Working Group's recommendations for fulfilling the objectives of the *Accord*.) Hence, investors will prefer products for which they must incur smaller costs, all other things equal.

Product providers can gain by providing investors with the information they require up to the point where the product providers' marginal cost of producing the information is equal to the marginal benefit (including savings from not having to get the information from other sources) obtained by investors. If there were no externalities (third-party effects) and no fraud, I believe that all economists would conclude that this is the optimal situation for the economy and for individuals.

Product providers similarly have strong incentives to determine the kind of information and mode of presentation and distribution that investors prefer. Economies of scale might dictate the provision by product providers of a common set of information, such as financial statements prepared in accordance with generally accepted accounting principles, to all investors. This reduces the cost of explaining the meaning of the numbers. Indeed, as the number of individual equity investors has increased, standardisation of the form and content of financial statements has increased (Benston, 1976). However, individual investors might want information that meets their specific needs, such as the tax consequences of debt and equity investments and the lifetime payouts of superannuation or life insurance investments. In these situations, product providers have incentives to determine and offer the specific information that would be useful to potential investors.

Much disclosure that is mandated by law or government regulation, on the other hand, is likely to be of no value to some or all investors and even possibly misleading. Investors, then, must bear the cost of studying and then rejecting this 'information' or of using the misleading 'information' to their detriment. At the same time, product providers must bear the cost of obtaining and reporting the useless or misleading 'information'. In a competitive market, although these costs are incurred initially by product providers, ultimately they will be borne by investors.

(b) Competition among product providers

In general, sellers can gain an advantage over their competitors by informing consumers about the qualities of their products compared with those of competitors. As a consequence, consumers often do not have to seek out information. For example, an issuer of unit trusts that is efficient or is willing to accept lower fees to attract additional investments has a strong incentive to inform potential investors about its relatively low expense ratio. Alternatively, some unit trusts with relatively high expenses might not publish this information. However, consumers are then likely to infer from the absence of information that trusts that fail to disclose expenses have something to hide. Unit trusts with low expenses also have incentives to point out this omission by their competitor to potential investors. The competitor, then, might point to other factors that are more important than expenses.

Thus, while it would be desirable for investors to inquire about expenses if they think these important (compared with other attributes), it is not necessary that they do so. It is sufficient for some unit trust managers to advertise this information and for some investors to take note of the information and act upon it. Competitors then have the incentive and the opportunity to convince investors that other factors are more important. The choice of what is or is not important, thus, is left to the investor.

(c) Incentives of some product providers to misinform or not inform investors

Product providers with inferior products have incentives to mislead or fail to inform investors about their products' shortcomings. However, under New Zealand law (and the law of most developed countries) misinformation is illegal. In its review of existing law (Part II), the Working Group describes present legislation and case law that prohibit product providers from engaging in conduct that is, or is likely to be, misleading or deceptive, from giving advice and offering products without reasonable care and skill, or from entering into contracts with investors without first informing them of inducements or rewards given to the product providers by third parties. For example, the Working Group states (para 45) that the Fair Trading Act 1986 provides that:

- a No person shall, in trade (which includes a business), engage in conduct that is misleading or deceptive or is likely to mislead or deceive;
- b No person shall, in trade, engage in conduct that is liable to mislead the public as to the nature, characteristics, suitability for a purpose, or quantity of services; and
- c No person shall, in trade, falsely represent that services are of a particular kind, standard, quality, or quantity, or that they are supplied by any particular person or by any person of a particular trade, qualification, or skill.

Thus, it is already illegal for product providers to give or withhold information that the provider knows or has reason to know will mislead or misinform investors.

Failure to inform could be considered to be misleading or deceptive; to that extent, it is already illegal. To the extent that it is not, potential investors in some financial products might not be informed about shortcomings or other negative aspects of these products. This problem might be solved in three ways. First, as discussed above, competitors have incentives to inform investors about the shortcomings of alternatives. Second, even if explicit information about a competitors' shortcomings is not offered to investors, they are likely to infer shortcomings by the absence of information.[4] The fact that one product provider offers apparently useful information while another does not can be taken as a 'signal' that information was not provided because it is unfavourable. Third, investors can be and are offered information services and advice or can rely on the reputation of investment providers, as is discussed next.

2.2.2 The Role of the Product Provider's Reputation

Product providers that intend to be in business for a long time obviously have a strong interest in developing and maintaining a good reputation for probity, service, and expertise, particularly in a small country such as New Zealand. Essentially, these are the products that they sell. Should it become known or even suspected that product providers cannot be trusted or are not competent, they not only will lose the business of those whom they mistreat, but of other present and future clients as well. Hence, product providers have a strong interest in providing non-expert investors with information that these investors would find useful, or in assuring them that their interests are well served.

The role of reputation is particularly important for insurance companies and superannuation plan managers. Their products are very long term, which necessitates fixed and firm-specific investments in analyst training, computer and accounting systems, marketing and the like that would be lost or considerably diminished in value if these firms lost the confidence of their clientele. Thus, although non-expert investors cannot rely on market prices impounding all relevant information about the value and risk of life insurance and superannuation investments, they can normally investigate and rely on the reputations of the providers of these investments.

2.2.3 Insufficient Production of Information Due to Externalities

Investors might benefit from information on investments that they do not make. Such information would permit investors to make comparisons among alternatives. Returns on and the risk of equities and other investments might be estimated better if investors had information about firms that produce competitive products. Although investors might be willing to pay for this information, there may be no practical way for the product provider to charge them for it. Hence, the desired information might be under-produced. Economists term this situation an externality or market failure.

However, three important factors mitigate or eliminate the externality. First, product providers can rarely exclude information from only some investors. Nor, in general, would they want to exclude any investor, since they cannot readily determine which investors are interested in their products and which want information only to evaluate a competitive product. Nor are product providers likely to forgo the opportunity of selling their products to potential investors.

Second, the possible externality could be, and in practice generally is, overcome by information services or specialists who gather and sell comparative information about investments. In the United States these services include Moody's and Standard and Poor's for securities and public debt issues, Morningstar for mutual funds (unit trusts), and SEI, Callan Associates and bank trust departments for pensions (superannuation schemes). These information companies and advisers are in the business of gathering and structuring comparative information that investors might value.

Third, government disclosure requirements would reduce the externality only if the specified disclosures were valued by investors and if the cost of producing and using the information did not exceed its value. Based on the discussion presented earlier, there should be great doubt that government agencies could devise specific disclosure mandates that would be more beneficial to investors than the information that product providers would provide. Indeed, there is reason to believe that government-mandated disclosure would result in investors being given confusing and misleading data that might be misused by them, in part because these data appear to be 'official'. Finally, as is discussed in the following section, the cost of government-mandated disclosure is likely to far exceed its benefits.

Based on the discussion above and presented next, there is strong reason to believe that government-mandated disclosure has not and would not represent an improvement for investors.

CHAPTER THREE

THE COSTS TO INVESTORS OF MANDATORY DISCLOSURE

Mandatory disclosure is costly to investors, since they actually pay the cost imposed on product providers. These costs include the expense to the product provider of developing the required data and taking steps to assure its accuracy. Although investors might be satisfied with reasonable estimates, product providers are well advised to forebear from offering estimates that might appear, *ex post*, to have been misleading or incomplete. Disclosure costs also increase as a result of increases over time in the amount of data that must be disclosed as new 'needs' are discovered and when, in a few instances, the requirements appear to have been inadequate. An important additional cost is imposed on investors who mistakenly believe that they have been given all they need to know, thereby lulling them into carelessness in their choice of investments.

The experience of the United States is particularly cogent.[5] The Securities Act of 1933 (which deals with new issues) and the Securities Exchange Act of 1934 (which deals with publicly traded securities) were modelled after the UK Companies Act's philosophy of disclosure to investors rather than government approval or disapproval of securities. Both countries' statutes require companies to present financial statements audited by independent public accountants and also information dealing with potential conflicts of interest (e.g. contracts with officers and directors and underwriting commissions and fees). In contrast with the UK Companies Act, the US statutes require corporations to report directly to an administrative agency, the Securities and Exchange Commission (SEC). The SEC is charged with administering several securities laws and with establishing and enforcing accounting disclosure requirements. Over the years, the SEC, directly or through its considerable influence over the public accounting profession, has promulgated an increasingly detailed, complex, costly and often restrictive set of rules (embodied in the SEC's Regulation S-X and Accounting Series Releases [ASRs], and in the Statements of Financial Accounting Standards [SFAS] published by the Financial Accounting Standards Board [FASB] and by committees of the American Institute of Certified Public Accountants [AICPA]). These rules were the result of the SEC's reaction to administrative problems in reviewing corporate financial statements, some scandals or apparent scandals, criticism in the press of seemingly misleading accounting by a few firms, political pressures, demands for complexity from those who benefit therefrom, demands by accountants and firms for protection from lawsuits made easier to mount by provisions of the securities acts, and changes in technology that made new financial products possible. As a result, the SEC has not permitted corporations to disclose some potentially useful information, while at the same time requiring corporations to present information of doubtful value to investors.

The SEC has not allowed corporations to offer some information that investors probably would find useful, largely because such disclosure would impose costs on the agency. Because registered companies' financial statements were made to and through the SEC, its employees were criticised if they 'permitted' some registrants to include information that was or appeared to be wrong. Consequently, the SEC forbade mining firms from including estimates of the market value of their oil or ore holdings because the validity of these numbers could not be established. Instead, corporations had to use cost-based numbers which could be verified, even if they were of little use to investors. Until recently, the SEC forbade corporations from including forecasts with financial statements, largely because it was difficult for the agency's employees to verify the numbers.

At the same time, corporations and investors have suffered from 'disclosure creep'. There have been instances when some investors wanted information that was not given to them by a company. These investors claimed (rightly or wrongly) that they lost money because they did not have the information. This put pressure on the SEC and on legislators to require all investment providers to offer the same information. The consequence has been greater and more costly mandatory disclosure imposed on all registered corporations. For example, in 1964 the SEC's specific disclosure requirements that were imposed on corporations with stocks traded on registered exchanges were extended to those with shares traded over-the-counter. Another example is the requirement that non-US corporations that want to be listed on US exchanges must meet the SEC's disclosure rules, even though their financial statements are accepted in their own countries and their shares can be purchased and sold by US citizens off the exchanges. Furthermore, the rules for reporting have become more and more detailed.[6] A perusal of the SEC's Regulation S-X and related ASRs, the over 120 SFASs put out by the FASB since its creation in 1973, and the 31 opinions, four statements, and 51 Accounting Research Bulletins issued by the FASB's predecessors all attest to the increasing complexity and detail of the rules governing accounting by US companies. Meeting these requirements has been very costly - a cost which is borne by investors in the corporations' securities.

Despite extensive and costly mandated accounting disclosure by US corporations, there is no evidence that the US securities market has become more efficient, that accounting reports reflect economic values better, or that investors have been better served. Numerous studies have shown that US stock markets were efficient before 1933, in that security prices impounded almost instantly in an unbiased manner all information that now is required to be disclosed. Furthermore, studies have shown that securities markets in other countries with much less required disclosure are as efficient as is the US market since the establishment of the SEC. As disclosure requirements have increased, market efficiency has not changed.

Finally, one might compare the market crash of 1929, which preceded and was responsible in large measure for the passage of the US securities acts, with the market crash of 1987, which was as great. The market recovered quickly from both crashes; the difference was that the 1987 crash was not followed several years later by an unrelated major depression. It is also worth noting that peoples' interest in investing in the US stock market did not return until the 1950s, well after enactment of mandated financial accounting disclosure. This experience provides little support for the belief that required disclosure is useful for encouraging people to invest in publicly traded stocks.

To the contrary. As was discussed earlier, it is unlikely that the information provided as a result of mandated disclosure would be sufficient for investors to make informed decisions, in part because of the complexity of these decisions and also because investors' needs differ both individually and for different investments. But, if past experience in the United States and, increasingly, other countries is a guide, mandated disclosure brings with it restraints on disclosure. Consequently, many investors will not be able to get information that would be useful to them. Furthermore, when disclosure is mandated by law or regulation, product providers who do not want to inform investors adequately can argue that the information they provide is adequate, because it meets governmentally determined requirements. As a consequence, non-expert investors might not exercise due care.

CHAPTER FOUR

CONCLUSIONS

In sum, although many of the Working Group's disclosure recommendations seem to be innocuous and of potential value to investors, there is reason to doubt their usefulness to investors. Certainly, there is no reason to believe that any uniform set of mandated disclosures can be effective for all investments and all investors. Consequently, the costs of mandated disclosure are likely to exceed the benefits to investors, thereby discouraging rather than encouraging people to save for retirement.

Fortunately, there is an alternative - voluntary disclosure driven by market forces. Competition among investment providers should be effective in giving investors the information they need and for which they are willing to pay. Nevertheless, it is possible (though very doubtful) that product providers misperceive what investors really want and are willing to pay for or that they produce less information than is optimal, since they cannot capture the full value of the information (externalities). The question then is whether disclosure mandated by a government agency or law is more likely to bring the information to investors in a cost-effective manner. The analysis given above indicates great doubt that this advantageous outcome would occur.

It is possible, though, that some degree of standardisation of information might be cost- effective. In general, the private market (individual companies, accounting societies, and information services) tends to develop the optimal structure. However, the government might play a useful role by *suggesting* standard formats and metrics. Any suggested standard or metric should be based on research showing the potential net benefits of the standards and their value and cost to market participants.

Finally, it should be recognised that the people of New Zealand have, or could have, a wide choice of investments that offer varying degrees of information. They can purchase securities offered by firms that are subject to US, UK, Australian, Japanese, Singaporean and other countries' laws and regulations if they want the 'protection' and cost of these laws and regulations. Consequently, New Zealand should consider eliminating all but basic disclosure requirements on its companies. If New Zealand investors want the extensive disclosure offered by, say, US-based companies, it is likely that New Zealand companies that want to attract these investors' funds will emulate the US standards. However, some (perhaps most) investors might want less or different information that imposes lower costs on companies, thereby allowing the companies to offer higher returns to investors. New Zealand law would still protect investors from fraud and misrepresentation. Giving New Zealand savers and companies more choice is, I suggest, the best way of achieving the mandate given to the Working Group - promoting the efficient allocation of the country's resources and enhancing peoples' willingness and ability to save.[7]

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