**NEW ZEALAND BUSINESS ROUNDTABLE**

# SUBMISSION TO THE MINISTRY OF ECONOMIC DEVELOPMENT ON THE REFORM OF SECURITIES TRADING LAW

**AUGUST 2002**

## Summary

1 This submission on the three volumes of discussion documents on the *Reform of Securities Trading Law* is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

2 Key points in the submission are as follows:

- there are many actions that the government could take in support of its goal of increasing confidence in the New Zealand sharemarket;
- the proposed regulatory approach and dynamic seems likely to make New Zealand's capital markets less liquid and less competitive. In our view the Ministry should take this concern very seriously;
- the documents effectively assume the efficacy of further regulations that ostensibly address a problem that may not exist in the pursuit of an objective that is not measured, and for which no measure of success is proposed;
- the presumption that confidence in the market can be improved by passing further legislation seems unwarranted. First, an attitude of legality could replace rather than complement an attitude of morality. Secondly, bad law penalises the law-abiding and brings the law into disrepute;
- the so-called 'fundamental review' of our insider trading legislation is not a fundamental review;
- the proposals for the regulation of market manipulation fail to identify the problem adequately and appear to have the potential to markedly reduce the liquidity of New Zealand markets;
- the government's key priority for capital market 'reform' (ie further regulation) appears to lack a sound basis and to be at odds with the

priorities that the Ministry ascertained from experts in the field when it first took responsibility for securities market legislation;

- we look to the Ministry to set high standards for regulatory analysis. A useful test of the quality of existing and proposed securities legislation is whether it is, or could be, supported by independent, professionally competent Regulatory Impact Statements. None of the legislation that is the focus of the current discussion documents appears to fall into this category; and
- we have no confidence in the process the Ministry appears to be following to finalise its views on these matters. Public policy analysis should not be about counting sometimes ill-informed and self-serving heads on matters that require a solid factual basis and professional analysis. If the Ministry wants submitters to commit significant resources to making submissions, it needs to give more thought to how it can better signal that facts, reasoning and serious professional concerns will be taken seriously.

# 1.0 Introduction

1.1 This submission on the three volumes of discussion documents on the *Reform of Securities Trading Law* is made by the New Zealand Business Roundtable (NZBR), an organisation comprising primarily chief executives of major New Zealand businesses. The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The NZBR has taken a close interest in securities market regulation. A recurring theme has been a plea for more rigorous analysis of problems and of the likely efficacy of proposed remedies. Those undertaking the analysis need to be familiar with the economic theory of regulation. Much of the poor quality legislation currently in place stems from the failure of governments to ascertain if there really is a problem that warrants legislation, and from shoddy analysis. In particular, public policy analysis commonly seems to lack a coherent theory of information.[1] For example, the drive to force disclosure of valuable information in securities markets contrasts with the drive to legislate for privacy and to protect intellectual property rights elsewhere in government.

1.3 In a lengthy submission in February 1998, we concluded that one of the problems in this area has been a weak performance on policy development and law reform over the years by the Securities Commission.[2] It has been a key promoter of many misconceived initiatives. Our list included the law relating to the disclosure of substantial security holders, controls on corporate takeovers, the law on insider trading and the development of investment product and adviser disclosure proposals.

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1 See University of Chicago Professor Richard Epstein on the broader topic, and on disclosure issues in company and securities law in particular, in *The Concealment, Use and Disclosure of Information*, New Zealand Business Roundtable, August 1996. See also the fuller analysis by Emory University Professor George Benston, *Voluntary vs Mandated Disclosure*, New Zealand Business Roundtable, May 1997.

2 New Zealand Business Roundtable, 'Submission on the Review of the Securities Commission', February 1998.

1.4 In the same submission we called for a fundamental review of the Securities Act 1978 and its subsequent amending acts, and we repeated that call in a submission on insider trading in 2000.[3] The Securities Amendment Act 1988 was rushed through after the 1987 sharemarket crash on the basis of claims that New Zealand was 'the last frontier of the Wild West'.[4] However, the October 1987 sharemarket crash was a global event that could not conceivably have been caused by any regulatory deficiencies in New Zealand. Its local magnitude was due not to insider trading but to the collapse of numerous heavily leveraged property and investment companies that were no longer viable with lower asset prices. Furthermore, our capital markets had endured and prospered for over a hundred years previously under a highly reputable English legal system backed by local laws and regulations dating back at least as far as the New Zealand Sharebrokers Act 1908.

1.5 In the absence of a sound framework for policy analysis, undue weight may be put on ill-examined presumptions such as the notions that:

- New Zealand will attract more overseas capital with more extensive prescriptive regulation;[5]
- New Zealand will attract more overseas capital from a country if it harmonises its regulations with that country;[6]
- more laws can lift standards of behaviour;[7]

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3 New Zealand Business Roundtable, 'Submission on the Insider Trading Discussion Document, October 2000.

4 See our October 2000 submission and Bryce Wilkinson, 'Insider Trading Legislation: Weak Analysis and Troubling Outcomes', in *Essays on Insider Trading and Securities Regulation*, Charles Ricket and Ross Grantham (eds), 1997.

5 The 1991 Ministerial Working Group on Securities Law Reform found that the evidence pointed in the opposite direction.

6 If the regulations are ill-suited to small, illiquid markets that are dominated by a few large players or major block shareholders, the opposite could well be the case. In the case of the recent implementation of the Takeovers Act 1993, the absurd claim was made that it was necessary in part to attract North American investors when in fact its mandatory bid provisions are not a feature of US federal law. The smaller New Zealand market needs to be less costly than the dominant market (for a given service) if it is to be competitive.

7 Bad laws undermine respect for the law and laws that legislate for morality tend to be bad law because the task is overly ambitious. For a view that New Zealand has already gone far too far in this direction, see Stephen Franks' comment that "Standards of honesty would be higher if we

- prices will more accurately track the underlying values of securities if market participants are better informed through mandatory disclosure;[8] and

had fewer laws more ruthlessly enforced", in 'Parliament must tidy up primitive law', *New Zealand Herald*, 5 December 2000.

8 Refer to the above references on the need for an informed theory of information.

- New Zealand markets would be 'the last frontier of the Wild West' without the intrusive and prescriptive legislation of the last 20 years or more.[9]

1.6 In our view it was, and is, grossly irresponsible of senior politicians, regulators and journalists to denigrate New Zealand capital markets as the 'last frontier of the Wild West'. The high weighting of overseas investment in our market rebuts the view that it is necessary for New Zealand to adopt overseas regulations in order to make investors confident about coming into our market. Indeed, one financial journalist has used that high overseas weighting to claim (absurdly) that more regulation is needed in order to increase *local* investor participation!

1.7 Claims about adverse 'perceptions' of the integrity of New Zealand capital markets often overlook a failure to enforce existing laws or to analyse the degree to which there is an actual problem. In all cases, the new regulations have raised the costs, risks and uncertainties of dealing in New Zealand markets without reducing the inexorable pressure to increase those burdens further. Expressed differently, in no cases do the additional regulations appear to have achieved their original goals.

1.8 The small New Zealand market cannot be expected to remain competitive under the burden of intrusive, industry-specific regulations that are designed for much larger markets. There is no hope for the future competitiveness of our capital markets if the evidence that we are losing competitiveness is used to justify additional regulatory burdens in order to 'promote confidence' in our markets.

1.9 The only safeguard against these trends is better analysis and a greater sense of constraint in removing shareholder choice and freedom of contract. It is very disappointing to find that the discussion documents pose questions rather than provide the necessary analysis. Worse, the questions they pose

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[9] This presumption ignores the common law and assumes that self-regulation is ineffectual. Yet financial markets have prospered for centuries without the legislation of the last 20 years.

for submitters overwhelmingly ask for opinions rather than analysis, facts or reasons. In our view this approach is largely a waste of time. Public policy analysis is not about aggregating diverse opinions. We question what basis the Ministry can have for weighting the responses it will get to its request for submissions.

1.10 If the Ministry desires to encourage detailed submissions of a professional nature, it must give such submitters some confidence that it is worth the trouble and expense of producing them. There is no point in commissioning a serious professional opinion on a matter if all that is being asked for is a head count.

## 2.0 The government's key objective and the key regulatory assumption

2.1 The Ministry's covering letter states that a key government objective is to promote confidence in the New Zealand sharemarket. It immediately makes it clear that the government believes that this objective can be best pursued by "a broad programme of reforms aimed at strengthening the regulatory framework to enhance the performance of, and confidence in, New Zealand's securities markets." It provides no measure of the current level of confidence and no evidence that it is low. Nor does it give any reason for believing that further regulation will raise rather than lower the level of confidence.

2.2 We would like to believe that the government is serious about promoting the performance of the New Zealand sharemarket. If it is serious about this goal, we would expect it to:

- refrain from attacking our market as 'the last frontier of the Wild West';
- not expropriate property rights, as in the Vodafone case and the proposed Kyoto forestry measures (and the restructuring of the electricity sector by the previous government), without due process and compensation;
- strongly discourage the Securities Commission from self-servingly attacking major companies or the market in general, perhaps in order to boost its own profile, regulatory powers or budget. Its impulsive and

incorrect attack on Telecom New Zealand's accounting standards illustrates our point;

- reverse the impression created by the increase in the top personal tax rate that the government favours higher tax rates on investor income;
- reverse its anti-privatisation stance so that companies like NZ Post, electricity SOEs and local authority trading companies have a chance of being listed on the New Zealand Stock Exchange;
- restore the independence of the New Zealand Stock Exchange and avoid driving it into the hands of an Australian exchange that may be more interested in shifting market activity to Sydney or Melbourne than in developing the competitiveness of New Zealand capital markets;
- reverse the presumption in favour of the harmonisation of regulatory regimes, recognising that smaller markets have less need for and are less able to sustain the costs of expensive regimes. New Zealand must seek to be more efficient if its capital markets are to compete with Australian exchanges for Australasian business;
- eliminate regulations that are not supported by an independent, professionally competent Regulatory Impact Statement;
- demonstrate a real determination to reduce the barriers to economic development in New Zealand posed by regulatory excesses;
- demonstrate greater faith in market processes and self-regulation based on a longstanding and proven English legal system. In particular, it should maintain the right to appeal commercial cases to the Privy Council and free up the stock exchange from state control and protection; and
- adopt a strategy for economic growth that is credible in the eyes of investors.

2.3 In respect of this list, the government needs to understand that investors take account of the full mix of its policies. When there are inconsistencies between what it says and what it does, its power to achieve its goals will be reduced.

2.4 Even so, the objective of promoting confidence itself looks *ad hoc* and overly narrow. It implies that the government could be satisfied if it achieved high confidence in a market that had become so uncompetitive and inefficient as to be insignificant.

2.5 The documents effectively assume the efficacy of regulations that ostensibly address a problem that may not exist in the pursuit of an objective that is not measured, and for which no measure of success is proposed. This is not sound analysis. Such a regulatory dynamic can only produce an inefficient and ineffectual regulatory morass.

2.6 All the proposed regulations will raise the costs, delays, risks and uncertainties of dealing in the New Zealand market. The complexities of the rules and the regulators' lack of adequate information will make their decisions fundamentally arbitrary. Company officers will spend more money on lawyers but their advice will be cautious and risk averse. Businesses will become more rule-bound and less competitive.

2.7 In part to justify their existence, the regulators will catch businesses out on technical violations of rules that are so difficult to interpret as to leave regulators with great scope to make arbitrary and unpredictable decisions. If businesses are expected to pay for clarifying rulings or interpretations, some may be commercially driven to fly blind and risk technical non-compliance. Technical violations will fuel the perception in the community that businesses are fundamentally dishonest. The regulatory dynamic can be expected to lead to further waves of regulation, as we have observed since 1987.

2.8 In the absence of any discernible offsetting benefit, the government must expect the costs it is adding to the domestic capital market to accelerate the shift of capital market business to Australia. Tasmania's capital markets have no discernible significance in an Australasian context. Current policies point to a similar future for New Zealand's capital markets.

## 3.0 Volume 1: Insider Trading Fundamental Review

3.1 This discussion paper poses forty-four questions for submitters. Of these, only the second part of question 44 asks for a reason. It asks why the costs of adopting the Australian approach to insider trading law might exceed the benefits. The other forty-four questions ask only for opinions.

3.2 Overseas governments and regulators may not want to see New Zealand governments adopt more efficient and less intrusive regulatory structures. They would naturally prefer New Zealand to 'harmonise' in favour of the larger country.

3.3 There is no reason to believe that Australia's insider trading laws have been designed to cater for the specific characteristics of the New Zealand market or for the interests of New Zealand investors. In any case, Australia's laws can also be expected to reflect pressures from a range of partisan interests, including the interests of their own regulators to expand their powers. Implicit in this question in the discussion document appears to be the view that a regulation exists because it produces a net welfare gain. This view, in the words of a major textbook on the economics of regulation, "has lacked supporters for several decades", in part because "a large amount of evidence … refutes it".[10]

3.4 Problem definition is critical to any competent public policy analysis. The discussion document considers the issue of the incidence of insider trading in paragraphs 33-37. No actual cases demonstrating that it is a problem in New Zealand are cited. Paragraph 36 refers only to anecdotal evidence from a "majority of submitters" Such an analysis puts a zero weight on the minority of submitters regardless of their authority or quality. It indicates to us that the NZBR might as well not have bothered to include an extensive section on this aspect as one of these submitters. The MED's 'head count' approach gives the same weight to, for example, the considered opinion of the chief executive of the New Zealand Stock Exchange as to that of the most prejudiced and ill-

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[10] Viscusi, W Kip, Vernon, John M, and Harrington Jr, Joseph E, *Economics of Regulation and Antitrust*, The MIT Press, Cambridge, Massachusetts, 2nd edition, 1995, p 326.

informed lay submitter. The discussion document also fails to make an assessment of the desired and undesired effects of the current legislation.

3.5 In respect of other questions in this document, our general comment is that there should be no government regulation of insider trading if that regulation is not supported by a professionally competent and robust Regulatory Impact Statement. Such an analysis would have to identify actual problems and move from symptoms to underlying causes. Asking people if they believe there is a problem does not meet this requirement. The required statement would also have to consider why the common law was deficient in not making insider trading an offence. We drew this to the Ministry's attention in our submission in October 2000 on its insider trading document. However, we note that this point and the paper by Denis Carlton and Daniel Fischel from which it was sourced do not appear to be acknowledged or referenced in this so-called fundamental review.[11]

3.6 In our view, no document is a fundamental review if it does not include an analysis of how existing legislation is working in practice compared to expectations, and of the reasons for these outcomes. However, the most lamentable deficiency is the failure to identify the problem with the necessary precision. This lack of coherence has been a problem from the start.[12] Another notable omission is its failure to assess the performance of the Securities Commission compared to expectations in respect of this legislation, and to address the problems of information and incentives that the Commission faces. The Commission's rationale for its recent decision in relation to the prime minister's comments on Air New Zealand shares could well have created widespread consternation and uncertainty as to how in future it will interpret this or any other legislation.

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11 However, paragraph 78 of the discussion document does acknowledge a common law remedy where there is a fiduciary relationship.

12 See the High Court's expressions of incredulity at the lack of policy coherence in the provisions in the Securities Amendment Act 1988 in *Haylock & Ors v Southern Petroleum NL* as cited in *The Capital Letter*, 25 TCL 29 .

## 4.0 Volume II: Market Manipulation Law

4.1 This discussion document poses twenty-four questions. Only two of these relate to reasons; the remainder all ask for opinions. The requested reasons relate to opinions as to whether the government should regulate market manipulation and, if so, should it be for the purpose or effect of the conduct.

4.2 Again the discussion document fails to establish that there really is a problem here or that the proposed laws would fix it even in theory, let alone in practice.

4.3 The discussion document competently highlights the difficulties with defining market manipulation (paras 40-44) but focuses (at paragraph 64) on (a) disclosure-based manipulation and (b) trade-based manipulation. It is not clear why "the common law tort of deceit" (paragraph 91) fails in respect of category (a). The regulation of so-called trade-based manipulation would appear to have the potential to capture all strategies traders use to move large orders in thin illiquid markets. Since New Zealand's markets are more illiquid than larger markets, the adoption of overseas legislation on this matter could be expected to raise the costs of transacting in our markets disproportionately. In particular, it would appear to have the potential to reduce the liquidity of our markets markedly.

4.4 Why would New Zealand shoot itself in the foot in such a manner? At paragraph 83 the document cites a survey of public opinion in 1992 that indicated that 44 percent of respondents believed that the sharemarket was manipulated and 77 percent thought that big investors can manipulate the market. Clearly, the thinner the market the more easily a single investor can move the market with a large order. If this is seen by the public to be manipulation, anything that reduces market liquidity is likely to increase the public impression that the market is vulnerable to manipulation.

4.5 The discussion document makes no attempt to assess how well-informed surveyed public opinion was on this issue. Market volatility is not a bad thing and occurs naturally in illiquid markets. The document appears to give

no consideration to the specific characteristics of the New Zealand market, or even to mention the liquidity issue.

4.6 Because of the low liquidity, it is commonly efficient for intermediaries (brokers) to manage large orders over several days in order to reduce the impact on the market of executing the order. The concealment of the existence of that order from competing dealers could well fall under any definition of market manipulation. The practice reduces market volatility and transaction costs. It is both efficient and desirable. There should be no attempt to prohibit such trading strategies.

4.7 Because public opinion is commonly not informed by a coherent theory of information, it is easy for commentators to presume that a fully informed market would be efficient. In fact, such a market might be highly illiquid and very inefficient because the returns from investing in information and transacting are much reduced. Such a market may barely exist at all.

4.8 The price volatility associated with illiquid markets could easily fuel uninformed public prejudices about unethical behaviour. Populist politicians will naturally seek to exploit this ignorance. There is a grave need for ministers and regulators to defend New Zealand markets from the attacks that occur whenever there is a major fall in prices. We see all too little of that.

## 5.0 Volume III: Penalties, Remedies and Application of Securities Trading Law

5.1 This discussion document lists fifty-six sets of questions. All the questions in each set ask for opinions. None asks for reasons or for factual information.

5.2 Since the existing legislation fails to address a well-defined problem and lacks a sound analytical framework, the answers to these questions are fundamentally arbitrary. Answers are likely to be inconsistent across questions and across submitters. The Ministry's interpretation of these responses will be inherently arbitrary.

5.3 Submitters will have diverse information sets and incentives. Their opinions will reflect this. The Ministry itself lacks the information and the incentives necessary to interpret the responses accurately, let alone determine what decisions would best serve the public interest. Sound decisions cannot be expected to emerge from this process.

## 6.0 Concluding comments

6.1 We have long argued that New Zealand needs better enforcement of longstanding legislation rather than more and more securities legislation. Legislation that endlessly expands the definition of a legal harm serves to increase the number of persons defined as criminals and the regulatory and enforcement burdens on the taxpayer. Its reliance on arbitrary distinctions and its incoherent basis seem likely to eventually reduce confidence in New Zealand capital markets.

6.2 New Zealand thrived until the 1950s at which time the statute book was relatively thin and the common law played a much larger role in governing market processes. New Zealand's long relative economic decline is associated with the big rise in government taxes, spending and regulation during the last 50 years. The attitude today is that the common law cannot cope with problems that it coped with for centuries. The greater the role for lawyers, regulators and statute law, the more we might expect an attitude of legality to replace an attitude of morality and the less say shareholders will have in determining the rules that would best serve their interests.

6.3 Successive governments have attempted to stem the flow of ill-conceived regulation on to the statute book through more disciplined process requirements, such as Regulatory Impact Statements. We would hope that this discipline would be applied in a professionally competent manner to the proposals in these discussion documents.

6.4 Tasmania is subject to the same regulations as the rest of Australia. Its capital markets have no visibility in an Australasian setting. If New Zealand is to continue to adopt regulations designed for much bigger and more liquid

markets, we can expect our capital markets to become increasingly inefficient, insignificant and invisible. The current trend for global investment banks to exit New Zealand and for our banks and insurance companies to be reduced to branch office status should heighten this concern.

6.5 It would be a pyrrhic victory to increase confidence in the New Zealand sharemarket by setting in train a regulatory dynamic that could reduce it to insignificance. However, that process would still be unlikely to achieve its goal. What is needed for civil society is an attitude of morality; this is not the same thing as an attitude of legality.

6.6 If the government is determined to increase the regulatory costs it is imposing on New Zealand's capital markets, one option would be for the Ministry to recommend that provision should be made to allow shareholders to opt out of the regime by common consent. We urge the Ministry to give serious consideration to this option.

6.7 When the Ministry first took responsibility for securities regulation it went to considerable lengths to survey expert opinion on public policy priorities in this area. The current thrust of regulation does not appear to be consistent with its earlier assessment of priorities. Has it changed its mind, and if so on what basis? If it has not changed its mind, has it done all it can to inform the government about what it sees to be the appropriate priorities? In particular, there appears to be no sound theoretical or empirical basis for the government's current key priority in business law reform.