

## Chapter 2

# Disclosure of Financial and Non-financial Information in the Marketplace

**Abstract** In this book we argue that today's disclosure laws fail to achieve their purpose of ensuring meaningful disclosure [To open up, to bring to light, to expose to view: Oxford English Dictionary, citing earlier usage such as 'the discoverie and disclosure of unknown places' (1598) and 'she sent downe lettres *mandatoires* vnto the Phenicians' (1487)]. There are many and growing numbers of overlapping disclosure laws which governments continue to add to by continuing to pass new disclosure laws in response to each 'boom' and each 'bust'. We argue that one of the reasons why the law is inconsistent is that there is no one disclosure standard and as a safety net as a basis for legislatures and courts. As a result, we recommend the introduction of a principles-based plain English standard with an ethical tone that 'You must keep the financial market fully informed'. We propose this disclosure principle to underlie the myriad of existing disclosure laws so as to set the standard and to provide a foundation for modern financial markets (including stock exchanges). This is not to replace existing laws, but to provide the foundation upon which they can sit.

To allege that disclosure law is unsatisfactory because its format is unsettled and inconsistent begs the question of how should it be settled. What should be the substance of disclosure law? This chapter will examine the policy and theoretical considerations which should, and sometimes do, shape the law of disclosure. It will be seen that there is no one theory of the 'law of disclosure' for financial services law beyond the current disparate disclosures required by legislation, by case law and by stock exchange rules.

- Nice figures, but are they nice facts?
- Consider the 'dentist who confessed that he tracked his stocks between patient visits, sometimes even between X-rays and fillings. First came class consciousness, then the royal road to the unconscious; now there was 'Dow consciousness'.<sup>1</sup>
- None of us knows tomorrow's closing prices (or if we do, we are liable [as insider traders]).<sup>2</sup>

---

<sup>1</sup> Fraser (2008), p. 180.

<sup>2</sup> Benjamin (2007), para 25.34.

## 2.1 Why Disclosure? Disclosure of Financial and Non-financial Information

In this book, we argue that disclosure laws in modern financial markets are made up of too many laws, regulations, self-regulatory rules, soft laws, releases and are subject to too many different standards. There are inconsistencies between common law and statute as the law appears to lack a firm theoretical basis. We will argue that securities regulation/financial services law fails to achieve meaningful and relevant disclosure to the market, and that the law fails to keep the market informed. Some disclosure is achieved, but how useful is it? Is it accurate, full, material, meaningful, relevant, timely? Even with disclosure laws, there is a discrepancy in what information is material to whom? Even with disclosure laws, there is evidence that the average prudent investor ignores the professional investor.

We demonstrate the paradox that the more disclosure regulation there is in financial markets by law, the less effective is the information because of overlap and duplication. The impact of more disclosure is diluted. We argue that complex disclosure has increased compliance costs, costs which are ultimately borne by consumers. We recommend a simple safety net to underlie disclosure requirements.

We argue that shortcomings in disclosure are inherently unfair to the credibility of the market and the stakeholders in the market such as investors and commissions. The inconsistency in disclosure law is also unfair as disclosure is regulated and enforced in some circumstances but not in others.

To allege that disclosure law is unsatisfactory because its format is unsettled and inconsistent begs the question of how should it be settled. What should be the substance of disclosure law? In this chapter we will examine the policy and theoretical considerations which should, and sometimes do, shape the law of disclosure. It will be seen that there is no one theory of the 'law of disclosure' for financial services law beyond the current disparate disclosures required by legislation, by case law and by stock exchange self-regulatory rules. We argue that one of the reasons that the law is inconsistent is that there is no one theory to assist with law making by legislatures and courts.

Academics from law and finance have developed economic models which try to explain how financial markets and their participants behave in certain situations.<sup>3</sup> Some of these models are constantly refined, while others are rigorously opposed. However, the concepts underlying these theories provide various insights on why the markets behave the way they do and implications for market regulation and information disclosure.

---

<sup>3</sup> See, e.g., Manela (2014), p. 181 (faster-diffusing information means quicker and less noisy profits, but increases competing informed trading which impounds more information into prices and erodes profits).

### ***2.1.1 The Implications of Information Asymmetries***

The central structural problem of all financial markets is information asymmetry between investors, intermediaries and issuers. The issuer knows more about the security than the investor and hence the information asymmetry. Unless they are directly related to the issuer, investors probably lack knowledge about matters that could be important for the investment decision. This resembles the so-called ‘lemons problem’ set out by Akerlof in the early 1970s.<sup>4</sup> His thesis was that information asymmetries that result in uncertainty about the quality of a product (for example, used cars) will lead to a decrease in the average used car price. Investors are not able to distinguish between good and bad quality cars (so called ‘lemons’) and will therefore only be willing to pay a lower average price. The result is that owners of good used cars will refrain from offering their cars in the ‘market for “lemons”’, resulting in a further decline of quality and prices. As Bernard Black has stated, the information asymmetries in securities markets make them a clear example of a lemons market.<sup>5</sup>

Information asymmetries are also present in the phenomenon known as adverse selection. The typical examples are insurance contracts that are offered without health examination so the insurer lacks knowledge about the customers’ health history (information asymmetry).<sup>6</sup> People with better health prospects are likely to accept other policies with mandatory examinations and they will get better contract terms. The higher percentage of customers with poor health results in higher treatment costs and forces the insurer to raise its fees, which is detrimental for all its customers, regardless of their health condition. Transposed to the securities markets, the concept of adverse selection suggests that badly informed investors will tend to choose investments which are less attractive and that this will result in a worse market outcome.

A closely related concept is the problem of moral hazard. This term describes the incentive for market participants to take risks where they do not have to bear the possible costs, or, more generally, to act in their own interest instead of the interest of the public. Relevant examples are the bail-outs of banks and insurance companies in the wake of the global financial crisis. Institutions which are too big (or too systemic) to fail can afford to enter into risky loan agreements because they can expect to be saved with taxpayers’ money in the event of a crash.<sup>7</sup> Another aspect of moral hazard is the incentive to cheat in the absence of penalties for cheating. In cases of information asymmetry the moral hazard is particularly strong, and parties which are insulated from risks have a strong tendency to behave inappropriately.

---

<sup>4</sup> Akerlof (1970), p. 488.

<sup>5</sup> Black (2001), pp. 781 and 786.

<sup>6</sup> See, e.g., Pauly and Nicholson (1999), p. 921.

<sup>7</sup> Stern and Feldman (2009).

A good example in the financial markets is insider trading. Issuers, their affiliates and current shareholders are in a favoured position in respect of information. They might make use of internal information to maximize their profits or to manipulate the markets.<sup>8</sup> Such conduct, or even rumours about such conduct, undermines investor confidence in the integrity of the financial markets and poses a threat to market efficiency; in particular, the cost of equity.<sup>9</sup>

### ***2.1.2 The Philosophy and Purposes of Promoting Information in the Marketplace (Disclosure)***

The philosophy and purpose of disclosure is to overcome information asymmetries by providing information for the market and its stakeholders including investors and shareholders, commission and governments. Disclosure needs to be proactive. The attitude that ‘those who need to know will know’ information for investment decisions is of little help and is unfair to stock exchange stakeholders. Such non-disclosure will further separate professional analysts and investors from the uninformed and especially retail investors (Mums and Dads).

Disclosure requirements are based on the premise that if there is sufficient transparency, the market will reject undesirable behaviour. Rather than being protected by law, the public will have information and will be better able to protect itself.<sup>10</sup> A stock exchange is often described as a market for information, and, like a sponge, it absorbs everything it can so that prices will rise with good news, and fall on bad news. Stock exchanges allocate a scarce resource (capital) among competing users. Stock exchanges reward successful companies, and punish the unsuccessful when investors move their capital away from underperforming or failing companies or other listed entities to entities with better prospects—the entities which place a higher value on the capital. Investors need information, and in the absence of information may choose to invest elsewhere than in financial markets and on the stock exchange.

This philosophy or rationale of disclosure of securities information is reflected in these IOSCO principles:

#### **E. Principles for Issuers**

16. There should be full, accurate and timely disclosure of financial results, risk and other information which is material to investors’ decisions.

17. Holders of securities in a company should be treated in a fair and equitable manner.

---

<sup>8</sup> Black (2001), pp. 796–799.

<sup>9</sup> Bhattacharya and Daouk (2002), pp. 75–77.

<sup>10</sup> See, e.g., Benjamin (2007), para 10.32.

18. Accounting standards used by issuers to prepare financial statements should be of a high and internationally acceptable quality.<sup>11</sup>

These principles are closely interrelated. While Principle 16 focuses primarily on full, accurate and timely disclosure of financial and non-financial information, the same qualities of disclosure are essential for the purposes of Principles 17 and 18.<sup>12</sup>

The policy behind mandatory disclosure is to correct disclosure of unequal possession of information among investors. Disclosure reduces and/or overcomes information asymmetry between management and shareholders, and among management and shareholders. It reduces estimation risk (the estimate investors put on a share). Disclosure enhances the share price, lowers shareholders' estimate of risk and it increases market liquidity for securities. But disclosure is not cost free. Section 2.1.3 (ECMH, discussed later) assumes that there is a zero cost to force the release of all information by a company in the way of disclosure to keep the stock market efficient and informed, and to ensure that it maintains a minimum standard of fairness.<sup>13</sup> Promoting and ensuring disclosure of information by regulation involves government commands (regulation) in the place of the economic forces of supply and demand.

Disclosure of information increases public and investor confidence in the market, and lowers the cost of capital.<sup>14</sup> Disclosure gives information to investors, whether sophisticated or unsophisticated,<sup>15</sup> but information is not free to produce. Those who produce information have paid for the information and they own it. They see the information as their private property, not public property, so they will naturally withhold 'their' information. They will be naturally reluctant to disclose it and they would not want to give away competitive advantage to the benefit of competitors.<sup>16</sup> As a result, markets for financial services will underprovide information with minimum and formalistic compliance with the myriad of modern disclosure laws.

Providing information sets standards of conduct. Disclosure produces additional financial data for the general public. It promotes efficiency, accountability, good corporate governance, informed voting by shareholders and better monitoring of management. It informs the general public, creditors and employees. It enhances investor protection.<sup>17</sup>

---

<sup>11</sup> International Organization of Securities Commissions (2010). See, e.g., Grover and Baillie (1979), pp. 384–393; Ogus (1994), chapter 7 (Information regulation).

<sup>12</sup> International Organization of Securities Commissions (2011), p. 90.

<sup>13</sup> Hence insider trading with non-public information will be able to earn abnormal returns.

<sup>14</sup> See, e.g., Botosan (2000), p. 60.

<sup>15</sup> There is little empirical evidence that sophisticated investors outperform the market: see, e.g., Jensen (1968), p. 389.

<sup>16</sup> See, e.g., Kitch (1995), p. 763 (private costs of disclosure do not exceed its social costs).

<sup>17</sup> See, e.g., Meier-Scatz (1986), p. 219.

### 2.1.3 *Efficient Capital Market Hypothesis (ECMH Disclosure)*

One of the purposes of financial market regulation is to ensure the accuracy of share prices and to ensure that prices do reflect the fundamental value of the company.

Disclosure law is influenced by the Efficient Capital Market Hypothesis (ECMH), which demonstrates that prices on financial markets fully reflect information and that they are informationally efficient.<sup>18</sup> This rests on three assumptions. First, investors are assumed to be rational and hence value securities rationally. Second, to the extent that investors are not rational, their trades are random and cancel each other out without affecting prices. Third, to the extent that investors are irrational in similar ways, they are met in the market by rational arbitrageurs who eliminate their irrational influence on prices. Such rational and informed behaviour will result in the most efficient use of the investor's resources, encouraging the flow of capital to firms with good prospects and resulting in allocation efficiency.<sup>19</sup> Conversely, informed investors will try to sell securities with bad investment prospects and this will lower the price of the security. As a result, investor protection is *per se* provided by the share price.<sup>20</sup>

The ECMH has been challenged by behavioural finance. This emerging discipline studies the effects of emotional, social and cognitive factors on decision making in the financial markets.<sup>21</sup> Behavioural models often draw on insights from psychology, and they question the assumption that markets participants are rational. In particular, individuals are biased by stereotypes and anecdotal evidence, and tend not to make decisions based on logic but rather on emotions and superficial assessments.<sup>22</sup>

An important connotation of the ECMH is the belief in the self-correcting powers of financial markets. If all market participants behave rationally, the likelihood of market crashes is low as informed investors will realize the dangers of overpriced products and start selling them before the crash occurs, mitigating the damage to the market. The subtext of this view is that rigid regulation of the markets is unnecessary, and that so-called 'light-touch' regulation (if any) is sufficient. This view was influential in the 1980s and 1990s. In the 2000s, however, a range of company collapses—such as Enron—and the Global Financial Crisis (GFC) from 2007 to 2008 dealt heavy blows to belief in the resilience of the

---

<sup>18</sup> The weak form of ECMH asserts that the market price of a share reflects all past public information and adjusts accurately and immediately to new information. The semi-strong version of the ECMH asserts that prices reflect all publicly available information. The strong form asserts that prices reflect all information, including hidden and inside information.

<sup>19</sup> See Coffee and Sale (2012), p. 6.

<sup>20</sup> Walker (2006), pp. 481 and 505.

<sup>21</sup> For an introduction, see Shleifer (2001).

<sup>22</sup> For discussion, see Walker (2006).

financial markets. The hard truth was that financial markets can fail, and that a collapse of the increasingly interconnected, globalized financial system can trigger a severe economic crisis. As a result, the debate on the reforms of financial markets regulation has shifted away from the concept of self-regulation towards a more interventionist approach.

Disclosure laws target the information upon which the ECMH is based. No investor can benefit from new information because prices will already reflect the information made available under disclosure laws. Modern financial services regulation recognizes the ECMH in its semi-strong efficient form as the best generalisation to summarize share pricing.<sup>23</sup> The ECMH is always influential when modern disclosure laws are being written, but it is only as good as the disclosure laws which underpin it, and there is scope for overreliance on ECMH to be revisited.<sup>24</sup>

The ECMH argues that investors are protected by the market's analysis of information released by disclosure laws which is widely available and is reflected in the prices 'often in milliseconds'.<sup>25</sup> With new technology, markets are now so efficient because prices are now based upon information supplied instantaneously to the marketplace. Market forces can now impound information so quickly that the arbitrage possibilities surrounding new information are much reduced. In the words of Judge Easterbrook:

The Securities and Exchange Commission believes that markets correctly value the securities of well-followed firms, so that new sales may rely on information that has been digested and expressed in the security's price.<sup>26</sup>

A market is efficient with respect to some specific information 'if prices act as if everyone knows the information'.<sup>27</sup> In an efficient capital market, the current price of a share will be the best estimate of the future price, because the current price will 'fully reflect' all available information about the future cash flows to the investors who own the share.<sup>28</sup> Features of an efficient market include large trading volumes, monitoring by large numbers of intermediaries including accountants, analysts, market makers and arbitrageurs who reduce cost to the individual of verification of information.<sup>29</sup> There is an efficient response to different kinds of information, as the impact one kind of information is different to the impact of another kind of information.<sup>30</sup>

<sup>23</sup> Langevoort (1992), p. 851. ECMH has been recognized by the SEC and the US Supreme Court: *Basic Inc v Levinson* (1988) 485 US 224.

<sup>24</sup> Coffee and Sale (2009), p. 707.

<sup>25</sup> Macey (1994), pp. 909 and 927.

<sup>26</sup> *Wielgos v Commonwealth Edison Co* 892 F 2d 510 (1989), quoted in Langevoort (1992), p. 851; Thomas and Cotter (2000), p. 105.

<sup>27</sup> Beaver (1981), pp. 23 and 35.

<sup>28</sup> Fama (1970), p. 383.

<sup>29</sup> See, e.g., *Freeman v Lavenhol and Horwath* (1990) 915 F 2d 193.

<sup>30</sup> See, e.g., Gilson and Kraakman (1984), pp. 549 and 556.

### 2.1.4 Implications

We argue that stakeholders still need reliable and timely information under disclosure laws for efficient allocation of resources and that they cannot just rely on the ECMH.<sup>31</sup> Even with disclosure laws, investors are alert to opportunities, have their eyes and ears open, have knowledge and they collect and use information.<sup>32</sup> Sappideen argues that the ECMH does not explain all investing, and the fact that individuals do not always act to maximize their utility is asserted by neoclassical economists.<sup>33</sup> In particular, there may be behavioural factors on the part of investors. Entrepreneurial theory explains share price movements to be the product of error prone guesswork by market participants, and that shares may be overvalued and bear no connection to their value.

Disclosure must be balanced with the fact that there is no ‘reasonable investor’, so a disclosure principle may result in required information being wasted or not understood. Stakeholders such as investors need accurate financial market information and financial product (securities) information for informed investment decisions. Commissions have to address better ways to communicate not what stakeholders should know, but what they need to know, so as to avoid ‘heard it on the grapevine’ and uninformed decision making. We support the research of, for example, Black who has cited qualitative empirical research on the behaviour of a sample of online investors which found a wide range of how and where investors obtained their information.<sup>34</sup> Evidence showed investor strategies ranged from diligent to dilettante, and an alarming lack of rationality by investors.

## 2.2 Voluntary Disclosure

Voluntary disclosure cannot be relied on to provide information to financial markets. Voluntary disclosure faces many forces including self-interest and the wish of the discloser to maintain self-protection. The flexibility of self-regulation can promote disclosure, but on the terms of the discloser. Management will have incentives to disclosure information, but it is under an equal number of pressures to prevent or avoid disclosure to protect its reputation—especially if there are things to hide. This suggests that expecting or relying on self-induced disclosure may be unrealistic and disclosure will only come when mandatory, whether enforced by commission or by stock exchange, or by coregulation by commission

---

<sup>31</sup> See, e.g., Gordon and Kornhauser (1985), p. 761; Kahan (1994), p. 977; Fox (1999), p. 1335 (private costs of disclosure exceed its social costs); compare Kitch (1995) (private costs of disclosure do not exceed its social costs).

<sup>32</sup> Sappideen (1988), pp. 133 and 161.

<sup>33</sup> Sappideen (2009), p. 80.

<sup>34</sup> Black (2010).



and stock exchange. It is not realistic for stakeholders (including investors and shareholders, commissions and governments) to rely on voluntary disclosure. The ability of stakeholders to sue may motivate disclosure, especially for misleading or deceptive conduct.

Disclosure is in the interests of corporations and other stock exchange users. An early view was that securities markets are best left unregulated by the state (the so called ‘null-hypothesis’).<sup>35</sup> Investor protection was provided by the existing rules of contract and tort. The underlying assumption is that issuers of financial products have a powerful motive to disclose all relevant information to investors because they can hence demand a higher price for their shares. A state-provided mandatory disclosure regime is accordingly either not required or harmful because it leads to higher compliance costs.

By making voluntary disclosure, the informed market will absorb the information and will ultimately correct in its favour. By avoiding disclosure, a company risks exposure should the market discover that bad or negative information has been suppressed. Making voluntary disclosure gives companies increased flexibility and control of information flow and media, and enhances the company’s ability to promote itself positively in the marketplace. Voluntary disclosure is part of self-regulation and voluntary compliance. Self-regulation and voluntary compliance is enhanced where corporate culture values and trusts an informed market.

The decision to disclose voluntarily is motivated by self-interest and self-promotion, but voluntary disclosure is no basis for disclosure to the market. There are many incentives to prevent the release of negative information to the market, yet self-interest dictates that individuals and companies may choose to voluntarily release news on its terms and at its timing. The discloser can signal good news and/or suppress bad news. Voluntary disclosure may pre-empt shareholders suing for misleading or deceptive conduct under corporate law or suing under common law for negligence or for breach of fiduciary duties. It may avoid and/or mitigate large price falls on earnings announcement dates, and will reduce the period of non-disclosure thereby reducing damages.

This raises the second problem of disclosure underlying the research question of this book—what is the most effective way to promote the disclosure of information to financial markets? Voluntary disclosure raises conflicts of interest between what management (self-interest) wants to release and what stakeholders want to know. Agency theory demonstrates that managers will voluntarily disclose good news and self-serving information to bolster their management.<sup>36</sup> There is a natural self-interest not to provide negative information regarding one’s competence and performance, on grounds including maintenance of confidentiality and not giving away a competitive advantage.

Paradoxically, it is in the interests of entities to voluntarily disclose bad news—to time or to manipulate the release of information rather than having the

---

<sup>35</sup> For a comprehensive overview, see La Porta et al. (2006), p. 1.

<sup>36</sup> This provides support for their position and benefits.

information leak out sooner or later. There are many incentives to motivate disclosure of bad news—such as bad loans, class actions, asbestos claims—which may already be factored into share values. Management may incur reputational costs if it fails to disclose bad news in a timely manner<sup>37</sup> even though management earnings forecasts increase market uncertainty in the short term when the news is adverse and/or the firm releases forecasts sporadically.<sup>38</sup> Kothari et al. confirm that managers delay disclosure of bad news relative to good news.<sup>39</sup> If managers accumulate and withhold bad news up to a certain threshold, but leak and immediately reveal good news to investors, the magnitude of the negative stock price reaction to bad news disclosure is greater than the magnitude of the positive stock price reaction to good news disclosures. Reliance on such voluntary disclosure of bad news is no basis for disclosure.

## 2.3 Mandatory Disclosure as a Response to the Failure of the Market to Provide Information

### 2.3.1 Introduction

We argue that despite the weight of policy and experience in their favour, mandatory disclosure laws alone will not provide full and material disclosure unless there is strong enforcement by means of coregulation. As discussed in Chap. 6 below, enforcement of mandatory disclosure by regulation by commissions alone (created by governments) is a good start, but it will not be as effective as coregulation with stock exchanges (building on their expertise and market experience). Commissions are too distant from the market. Private sector intervention alone (by means of litigation) may force mandatory disclosure in specific situations, but this may not result in across-the-market mandatory disclosure to the benefit of all stakeholders, including investors and governments. The weight of experience, and the IOSCO template on the principles of securities regulation,<sup>40</sup> show the need for coregulation with input from the stock exchanges based upon their market and industry experience.

#### 2.3.1.1 Definition of Mandatory Disclosure

Mandatory disclosure (obligatory, compulsory, not discretionary) refers to intervention by the government (commission) to force companies and other entities to disclose information. When armed with information from mandatory disclosure,

---

<sup>37</sup> Skinner (1994), p. 38.

<sup>38</sup> Rogers et al. (2009), p. 90.

<sup>39</sup> Kothari et al. (2009), *Journal of Accounting Research*, available on SSRN.

<sup>40</sup> International Organization of Securities Commissions (2010).

stakeholders (including investors and shareholders) can evaluate investment opportunities and allocate their capital with informed choice.

Proponents of mandatory disclosure argue that the existence of appropriate disclosure requirements may reduce the variation associated with returns on investment and consequently increase the efficiency of the securities market as a mechanism for the allocation of capital. In particular, mandatory disclosure requirements may force the disclosure of adverse material information to the market where otherwise there would be little incentive for the company to disclose.

Mandatory disclosure recognizes that because information is a public good,<sup>41</sup> private markets will produce too little information because the producer of information cannot capture its full value. The producer of an ordinary ('private') good can and may control those who will receive it. Providers of public goods cannot stop who will obtain the information as they cannot exclude people (non-excludability of later users) who have not paid for them (such as freeloaders). Like the provision of public television, public transport and public parks, disclosure of public information is likely to be underprovided. Being public goods, one person's use of the good does not affect the total supply of the goods available to other persons.

Underproduction of information is market failure. This can only be overcome by mandatory disclosure to enhance the credibility of information so that investors will not discount the information as lemons.<sup>42</sup>

In typical financial market regulation regimes, mandatory disclosure is either continuous periodic disclosure—where companies provide information to the market at regular fixed intervals—or continuous disclosure, where companies must disclose information as it arises.

As discussed below in Chap. 3, the number of disclosure laws continues to expand in response to each 'boom' and 'bust' without any rationalisation of their overlap, inconsistencies and efficacy. These disclosure laws would be stronger if built on the principles-based recommendation of our book with an ethical and public interest tone. For example, there are calls for more mandatory disclosure in the form of online quarterly reporting. There could be more mandatory disclosure with the strengthening of regulation governing preliminary final reports. This raises the question of whether more mandatory disclosure produces more and meaningful information, or is mandatory disclosure another type of standardisation which produces standard information? Management discussion and analysis reporting could be clarified, strengthened, monitored and enforced.<sup>43</sup>

Mandatory disclosure regulation moves the costs of collecting and producing information from the financial services industry (brokers) to the issuers of financial products. This cost for the issuer may well be smaller than the costs of brokers to search for and research the information. Modern financial services (securities) regulation usually make no allowance for the cost of mandatory disclosure. It forces

<sup>41</sup> See, e.g., Coffee (1984), pp. 717 and 723; Ferrell (2007), p. 81.

<sup>42</sup> See, e.g., Cox (2009), pp. 941 and 959–961.

<sup>43</sup> North (2009), p. 23.

minimum levels of disclosure which may or may not be wanted by some investors. There are provisions for less disclosure for wholesale investors, but there is little provision for a retail investor who does not want to pay for unwanted information to voluntarily buy a financial product with no disclosure.

### ***2.3.2 In Support of Mandatory Disclosure***

Mandatory disclosure must be supported to achieve disclosure of information in the market. Mandatory disclosure is more effective as it has the potential to lead to a more efficient market if supported by coregulation, for at least four reasons. First, the promotion of investor confidence; second, the promotion of allocational efficiency; third, the discouragement of fraud and misrepresentation; and fourth, the promotion of accountability. These considerations are nowadays backed by a substantial body of empirical research.

#### **2.3.2.1 Mandatory Disclosure Promotes Investor Confidence**

Mandatory disclosure limits the right to remain silent—to cover up—so that all investors have access to the same information. Because mandatory disclosure underpins investor confidence and promotes efficient and effective financial markets, mandatory disclosure is good for financial markets.

Mandatory disclosure does result in the production and the disclosure of information that would not otherwise have been disclosed voluntarily. Mandatory disclosure also controls the time and the method of disclosure. Mandatory disclosure therefore generates more information for investors allowing the market to make informed and intelligent investment decisions, in line with the IOSCO principles discussed above.<sup>44</sup>

Mandatory disclosure reduces the cost of inefficiency in the market. Mandatory disclosure overcomes the even greater inefficiency of no mandatory disclosure, where the market is uninformed—without it, investors would have to attempt their own research and inquiries. Mandatory disclosure reduces investors' research burden:

The current system (mandatory disclosure) is more analogous to making the casino disclose which slot machines have paid off, in which order, in the last month - this does not improve the gambler's odds at all, but it may encourage those gamblers who profess to see a 'pattern' in the slot machine payoffs.<sup>45</sup>

Mandatory disclosure makes it easier for stakeholders including analysts to search for, gather, analyse, verify and test information including past history in

---

<sup>44</sup> International Organization of Securities Commissions (2010), principles 16–18.

<sup>45</sup> Mahoney (1995), pp. 713 and 744, quoted by Kahan (1997), pp. 1509 and 1513.

order to estimate future earnings and dividends.<sup>46</sup> There is no evidence that fuller and earlier disclosure will not affect underlying profitability or performance of management and/or a company.

### **2.3.2.2 Mandatory Disclosure Promotes Allocational Efficiency**

Mandatory disclosure enhances the allocative (allocational) efficiency of capital markets and reduces price dispersion to enable investors to make an informed choice among different and competing investment opportunities. Prompt disclosure provides a brake on unaccountable and possible reckless corporate activities. It could contain a failure and the extent and size of losses.

Without mandatory disclosure, there is overinvestment in or duplication of research by investors resulting in ‘social waste’.<sup>47</sup> This leads to the research question of our book set out in Chap. 1—whether disclosure laws result in financial markets being more informed or less informed—and the subsidiary problems of cost, conflict and ‘how to?’ which test the hypothesis that mandatory disclosure can assist in overcoming social waste.

### **2.3.2.3 Mandatory Disclosure Discourages Fraud and Misrepresentations**

Mandatory disclosure regimes require information disclosed not to be misleading, deceptive or fraudulent. A mandatory disclosure regime serves to keep the market honest and informed by ensuring full disclosure is made to the market.

Where insufficient or misleading or fraudulent information is released, shareholders and other creditors may take legal action against a company and its directors. It can be argued, therefore, that mandatory disclosure regimes have a deterrent effect on litigation. It can be argued conversely that the technical requirements imposed on mandatory disclosure documents can mean that simple or technical errors may become grounds for legal proceedings.

Mandatory disclosure is also a deterrent to fraud and manipulation of the market or of information being disclosed, and can serve to slow down rumours, rumourtrage, fraud and false reports by maintaining honesty in the market. Its backstops are the laws prohibiting misleading or deceptive conduct and anti-fraud laws such as rule 10b-5 in the United States,<sup>48</sup> and equivalent laws in other

---

<sup>46</sup> Sale and Fisch (2003), p. 1035.

<sup>47</sup> Neagle and Tsykin (2001), p. 5.

<sup>48</sup> SEC Rule 10b-5 is codified at 17 Code of Federal Regulations (CFR) § 240.10b-5. It was passed (promulgated) by the Securities and Exchange Commission under its authority in the *Securities Exchange Act of 1934*.

jurisdictions.<sup>49</sup> Misleading or deceptive conduct regulation in the US under rule 10b-5(2), which prohibits the omission to state a material fact, includes a duty to correct statements if updated information is available. Non-disclosure may also be treated as unconscionable conduct.<sup>50</sup> Mandatory disclosure fills an information void by providing reliable public information. One question is whether mandatory disclosure regimes are necessary if the market can be protected by action for misleading or deceptive conduct rather than trying to cut down the size and information in advertisements to avoid liability under mandatory disclosure laws?

### 2.3.2.4 Mandatory Disclosure Promotes Accountability

Shareholders and management have divergent interests. Disclosure of information by management could threaten their position. Mandatory disclosure does allow market participants to assess manager risks, but there is still evidence that investors who have material information may not necessarily choose to act on it. Mandatory disclosure provides a control for the accountability of management in the Berle and Means model of the separation of ownership and control and the market for corporate control.<sup>51</sup> As such, mandatory disclosure is a spur to greater management efficiency. It may require disclosure of misconduct including misuse of inside information by management.

There is ample evidence that management will seek to provide a minimum of information and only the information that investors want,<sup>52</sup> which the booms and busts over the years indicate may be very little. Naturally management will wish to withhold information to avoid assisting competitors. Mandatory disclosure laws require management to disclose what might be considered confidential information, including details of litigation and legal settlements. Mandatory disclosure may give too much power to competitors, and too little to investors.

Private or competitive methods of ensuring disclosure, such as information intermediaries, would be an ideal for mandatory disclosure but the problem remains how to get informed traders. Compliance systems may prove to be an effective management tool, with a mix of innovative regulatory strategies and voluntary corporate use of compliance systems. Regulators could recognize and reward good corporate governance and disclosure and value voluntary self-evaluation and disclosure of potential breaches.<sup>53</sup> Important steps in this direction are, for example,

<sup>49</sup> See, e.g., in Australia: *Corporations Act 2001* (Cth) s 1041H; *Competition and Consumer Act 2010* (Cth) Schedule 2 Australian Consumer Law s 18; in Germany: *Gesetz gegen den unlauteren Wettbewerb* [Unfair Competition Act] (Germany) § 5; in New Zealand: *Fair Trading Act 1986* (NZ) s 9.

<sup>50</sup> Pearson (2005), p. 105.

<sup>51</sup> Berle and Means (1932).

<sup>52</sup> Gilson and Kraakman (1984); Easterbrook and Fischel (1984), p. 669; Easterbrook and Fischel (1991), pp. 290 and 291, cited at Neagle and Tsykin (2001), n 15.

<sup>53</sup> Parker (1999), p. 178.

immunity policies to encourage the disclosure of cartel conduct, with immunity from prosecution by the first to report cartel conduct.<sup>54</sup>

### 2.3.2.5 Empirical Evidence

These theoretical arguments for mandatory disclosure are backed by empirical research from law and finance literature which suggests that investors provide less capital if their interests are not properly protected.<sup>55</sup> Influential works were published by La Porta, Lopez-de Silanes, Shleifer and Vishny between 1997 and 2006.<sup>56</sup> Based on the assumption that a financial market's regulatory framework has an impact on market development (so called 'law matters' thesis), La Porta et al. identified a correlation between market growth and disclosure-based investor protection.

## 2.4 Mandatory Continuous Disclosure

We argue for the need for mandatory continuous disclosure of information in the form of a simple principles-based statement to support the disclosure coregulation by commissions and stock exchanges and to provide a safety net for the current disparate and piecemeal disclosure regulation. It confirms the importance of the existing mandatory continuous disclosure in coregulated environments, and supports the research by Corbett which argues for more effective mandatory continuous disclosure when it is built on a foundation of self-regulation.<sup>57</sup>

Continuous mandatory disclosure aims to keep the financial market informed by overcoming the inability of market forces to guarantee adequate and timely disclosure.<sup>58</sup> Relevant information must be continuously available to achieve an informed market. Continuous disclosure, coupled with today's online instantaneous accessibility,<sup>59</sup> acts as a further or a substitute warning device. Continuous disclosure will require and therefore will encourage the growth of information systems. It reduces the possible distorting effects of rumours. It reduces the opportunities for fraud and insider trading. By making information available on a continuous basis, continuous disclosure improves management performance. However, and despite the increasing number of disclosure laws, mandatory disclosure is a hard standard to achieve.<sup>60</sup>

---

<sup>54</sup> See, for example, European Union, *Commission Notice on Immunity from fines and reduction of fines in cartel cases*, OJ, 8.12.2006, C 298/17; Australian Competition and Consumer Commission (2009).

<sup>55</sup> For an overview see Bhattacharya and Daouk (2009), pp. 577 and 578; Black (2001), pp. 834–838.

<sup>56</sup> La Porta et al. (1997), p. 1131; La Porta et al. (1998), p. 1113; La Porta et al. (2006).

<sup>57</sup> Corbett (1999), p. 506.

<sup>58</sup> Mandatory continuous disclosure is either continuous disclosure or periodic disclosure.

<sup>59</sup> See, e.g., Coffee (1997), p. 1195.

<sup>60</sup> Reyes (2002–2003), p. 147.

Timely and continuous disclosure is an important part of mandatory disclosure to enable informed decision making. Australia is a good example of how statutory disclosure obligations and stock market rules interact and form the overall disclosure framework for listed entities.<sup>61</sup> The *Corporations Act 2001* (Cth) in Chapter 6CA requires a 'listed disclosing entity' to provide continuous disclosure of material information to the stock exchange if this required by the listing rules and to the Australian Securities and Investments Commission (ASIC). This is enforceable by civil penalty provisions and/or criminal penalties for non-compliance.<sup>62</sup> Some breaches of continuous disclosure have led to enforcement by the courts,<sup>63</sup> and by ASIC enforceable undertakings.<sup>64</sup> In Ontario, this is stated as 'where a material change occurs in the affairs of a reporting issuer, it shall forthwith issue and file a news release' [*Securities Act 1990* (Ont) s 75(1)]. This approach can be found in most jurisdictions around the world, for example in Saudi-Arabia.<sup>65</sup>

These continuous disclosure laws raise the question of the extent to which directors and senior executives can rely on their own judgment on when to disclose and on what to disclose.<sup>66</sup> Questions have also been raised on the effectiveness of this listing rule, and the extent to which these rules can be, and are in fact, monitored and enforced within the current regulatory structure.<sup>67</sup>

The impact of the enhanced disclosure regime on corporate disclosure policies is mixed. There is no evidence that enhanced disclosure (ED) unequivocally has improved share market efficiency, but there is research that it may have had an effect.<sup>68</sup> Further, Carlin has provided research questioning whether continuous disclosure has provided informed markets, arguing that good governance is the product not so much of the existence of layer upon layer of regulation coupled to edifices built high with arcane technical rules and provisions. It flows, instead, from the recognition and defence of principle.<sup>69</sup>

---

<sup>61</sup> Equally, e.g., in Europe, continuous disclosure was partly harmonized by the *Directive on the Harmonisation of Transparency Requirements* (2004/109/EC, 15 December 2004, OJ L 390, 38); in Germany: *Wertpapierhandelsgesetz* [Securities Trading Act] (Germany) § 15 ('WpHG'); in New Zealand: *Financial Markets Conduct Act* (NZ) Pt 5 Subpart 4; in Ontario: *Securities Act* RSO 1990, Chapter S5 (Ontario) Part XVIII (Continuous disclosure).

<sup>62</sup> *Corporations Act 2001* (Cth) s 1317E, ss 674(2) and 675(2) respectively. The Criminal Code applies to offences in these sections (s 678).

<sup>63</sup> See, e.g., *Jubilee Mines NL v Riley* [2009] WASCA 62; (2009) 27 ACLC 164, earlier proceedings discussed by Coffey (2007), p. 301.

<sup>64</sup> See, e.g., Neagle and Tsykin (2001), p. 15.

<sup>65</sup> In Saudi Arabia, listed companies must disclose all material developments without any delay by posting them on the Saudi Stock Exchange's (Tadawal) website, enabling investors to know the latest developments in company activity and its internal material news, see Capital Market Authority (2013).

<sup>66</sup> Reichel (2010), p. 84.

<sup>67</sup> North (2009), p. 75.

<sup>68</sup> Brown et al. (1996), cited by Blair and Ramsay (1998), pp. 55 and 65; Brown et al. (1999), 35 *Abacus* 138.

<sup>69</sup> Carlin (2006), p. 33, available on SSRN.



Cassidy and Chapple recommend more private enforcement of disclosure breaches including class actions to increase pressure on companies to comply with the mandatory disclosure standards.<sup>70</sup> A report from the University of Melbourne has expressed concern at the track record of continuous disclosure and demonstrated evidence of a lack of candour where mandatory continuous disclosure regimes are in place.<sup>71</sup> The research team had examined a large number of queries issued by the Australian Securities Exchange (ASX)—often multiple queries—and found the quality of responses poor and that the companies were reactive and not proactive in their disclosure. Langley<sup>72</sup> has pointed out that the sanctions available to ASIC for corporate non-disclosure under this law been progressively strengthened.

The policy for effective continuous disclosure led to the grant of further power to ASIC in 2004 to issue infringement notices to fine companies to provide a quick response for minor violations of the continuous disclosure obligations, yet evidence demonstrates that the infringement notice regime continues to fall short of its objectives.<sup>73</sup>

Mandatory disclosure is also required in ASX Listing Rule 3.1 which introduced a positive requirement for mandatory continuous disclosure of materially price-sensitive information by listed disclosing entities.<sup>74</sup> ASX Listing Rule 3.1 requires disclosure of information which is likely to have a material effect on the price or value of an entity's securities. This listing rule is no longer the private rule of private body and is enforceable (by coregulation) by inter alia ASIC, the stock exchange or a 'person aggrieved' under *Corporations Act 2001* (Cth) s 793C and there is wide scope for the enforcement of ASX LR3.1 (and equivalents). It has the benefit and efficiency of coregulation by ASX and ASIC.

## 2.5 Three Problems with Mandatory Disclosure

### 2.5.1 *The First Problem of Mandatory Disclosure: Information Is Not Cost Free*

Providing the disclosure as required by legislation and case law (fiduciaries, usage, implied term, as discussed in Chap. 4)—imperfect and incomplete as it may be—is not costless. It raises the issue of who is going to bear the cost of disclosure.

The direct costs of disclosure regulation include the costs of creating and collecting information (data), and then storing, retrieving, presenting, analysing

<sup>70</sup> Cassidy and Chapple (2003), p. 81.

<sup>71</sup> Neagle and Tsykin (2001), p. 41 and Donald (1999), p. 85.

<sup>72</sup> Langley (2007), p. 439.

<sup>73</sup> Criticized by, e.g., Baxt (2004), p. 290; ASIC Continuous disclosure Obligations: Infringement Notices (May 2004); queried by, e.g., Golding and Kalfus (2004), p. 385.

<sup>74</sup> For discussion of listing rules in general, see Chap. 7.

and interpreting the information. There are more direct costs in dissemination (mail, printing, uploading, online distribution). There are costs of compliance,<sup>75</sup> including the costs of learning to comply with new laws and the requirements of disclosure regulation. In addition, there are litigation costs (compliance and enforcement costs), opportunity costs and start-up costs. There is evidence that this government-mandated disclosure is costly compared to its benefits as it does no more than build on existing voluntary disclosure. For this reason, some have argued for ‘dismantling’ of mandatory disclosure on the basis that removal would not distort the pricing mechanism.<sup>76</sup>

Indirect costs of disclosure regulation include the potential loss of corporate advantage—by disclosing too much to the market and to competitors—which could impact on future profits, risk of shareholder legal action, the loss of time, and the loss of flexibility.

Costs can lead to the stifling of innovation and creativity—due to interaction between different laws which may be conflicting or inconsistent, uncoordinated, constantly changing, poorly targeted, ad hoc and often with short implementation timeframes. There may be difficulties with multiple and uncoordinated licensing and approvals processes, lack of delineation between the roles of regulators, lack of clarity over regulators’ powers and their objectives in exercising those powers. There may be lack of coordination between regulators, ‘zero tolerance’ attitude of regulators all backed up with excessive and growing personal liability of directors. Forcing disclosure has to face and overcome vested interests and self-interested behaviour. There is opportunity cost in disclosure, when people make a choice to disclose or not from one alternative (opportunity) or the other.

There is evidence that the factors which affect the content or timing of financial statements and disclosure include:

- regulatory forces;
- market forces, and
- the costs associated with these disclosures.

These three factors can result in information release to the public which may not always be the most timely or unbiased subset of that available to internal parties.<sup>77</sup> If the costs of disclosure are too high, there may be market failure in providing public information, which will lead to failure to attribute the true value of information.<sup>78</sup>

---

<sup>75</sup> See, e.g., Parker and Conolly (2002), p. 273.

<sup>76</sup> See, e.g., Phillips and Zecher (1981), p. 114.

<sup>77</sup> See, e.g., Foster (1986).

<sup>78</sup> Neagle and Tsykin (2001).

### 2.5.2 *The Second Problem of Mandatory Disclosure: Conflict of Interest*

There is a danger that disclosure may be limited by self-interest rather than the public interest.<sup>79</sup> We all face conflict of interest—‘The doctor who is considering whether to prescribe pills and send you home or to operate is facing a conflict’.<sup>80</sup> Financial regulation laws are constantly adjusting to new situations, especially following a corporate collapse (a boom and bust). There is the danger that when there is input from stakeholders, the input is corrupted by the self-interested and lobbyists who do not reflect the public interest. This may result in new legislation being sourced in self-interest, not the public interest. Market forces will be limited by self-interest, and Adam Smith’s invisible hand cannot be relied on to provide information of the quality or quantity needed:

The directors of such (joint stock companies), however, being the managers rather of other people’s money rather than their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master’s honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.<sup>81</sup>

There are many stakeholders and interests in financial markets to satisfy. Players in the market include IOSCO, government, Treasury, politicians, commissions, stock exchanges new and old, stockbrokers associations, brokers (participants), financial planners, companies and listed entities, entrepreneurs, investors, institutions, law reformers, legal and accounting professions. Other groups benefit from financial market regulation so it would not be in their interest to oppose it.

Financial statements are seen as the equilibrium outcome of individuals maximising their own self-interests. Watts provides a further example of self-interest with the example of the accounting profession and its ‘control’ of accounting information.<sup>82</sup> Accountants will insist that only they—not advisers, analysts, bankers—are qualified to provide accounting advice and to prepare accounts. Equally, auditors will want registration to keep out competing unqualified auditors. Governments may be beneficiaries of regulation, and government regulators (bureaucrats) in both government and commissions who administer disclosure regulations gain prestige, promotion and income from new regulation.

---

<sup>79</sup> Under the Pareto concept, regulation is in public interest if improves one person’s condition without worsening another’s condition. Disclosure in the ‘public interest’—improves one person’s condition without worsening another person’s condition (Pareto optimality).

<sup>80</sup> Panel Discussion (1972–1973), p. 545 per K.L. Bialkin.

<sup>81</sup> Smith (1776), p. 700, quoted, e.g., Sappideen (1987), pp. 67 and 68.

<sup>82</sup> Watts (1977), p. 53: ‘I cannot see the accounting professional bodies ever publicly accepting the theory outlined here. It assumes that accountants act in their own self interests’.

### 2.5.2.1 Input into New Laws

Individuals and the electorate who rely on and who are influenced by the media may not be fully informed. The role of the media is not to give advice and information. Politicians and regulators act in their own self-interest, and neither financial regulation legislation nor the actions of a securities commission in determining rules and regulations are necessarily motivated by the wish to provide optimal accounting information in the sense of being Pareto optimal. Commissions gather information only from those prepared to prepare it and their recommendations are based on ‘perceived’ problems. Some assert that regulators tend to go for low risk strategies and tend to take a conservative view to innovation, and that regulation favours producers in recession and consumers in times of boom.

### 2.5.2.2 Conflicts of Interest on Disclosure: Agency Costs

An important efficiency justification of mandatory disclosure is to reduce agency costs, thereby overcoming another cause of market failure.<sup>83</sup> Agency theory<sup>84</sup> recognizes the principle of self-interest in the principal/agent relationship, where management (the agents, who have day-to-day control) may have different interests to the shareholders (the principals, who have ownership). Disclosure will allow the monitoring of what the agent is doing to ensure that the agent is acting in the interests of the principal. Agency costs are the costs to control inappropriate conduct in the principal/agent relationship, such as limiting the powers of management or why a corporation introduces a profit sharing scheme so that the self-interest of management is in line with the self-interest of the owners.

More frequent reporting cannot directly affect the profits of a company but it can lessen failure through poor management, misreading of markets, underestimation of competitors, getting the timing wrong and so on. It is said that disclosure is greatest in the more successful and faster-growing companies.

Mandatory disclosure can help to reduce the possibility that management will misuse assets because it increases the amount of information about management’s decisions. This amounts to an efficiency argument for disclosure.<sup>85</sup> Mandatory disclosure reduces the cost to shareholders of monitoring agents by giving shareholders more information to control management. Jensen and Meckling found that audited financial statements and financial disclosure might reduce agency costs.<sup>86</sup> They argued that if shareholders find it worthwhile to use detailed financial statement to monitor managers, it will be cheaper for the manager—who has access

---

<sup>83</sup> Jensen and Meckling (1976), p. 305.

<sup>84</sup> Agency theory examines the cost of the divergence of the interests of managers and the interests of shareholders.

<sup>85</sup> Neagle and Tsykin (2001), p. 5; Mahoney (1995), p. 1047.

<sup>86</sup> Jensen and Meckling (1976).

to internal records—to produce this information than for the shareholder to obtain it. This means that it would better for the manager to agree in advance to cover the cost of providing these reports and to then have their accuracy tested by an external auditor.

Agency theory predicts that managers will voluntarily disclose information to limit the divergence of interests. Information will be disclosed until the marginal benefit of disclosure (the reduction in agency costs) just offset the marginal costs of disclosure. This disclosure will be consistent with Pareto efficiency.

There is demand for companies to provide shareholders, analysts and other stakeholders with adequate information for predicting, comparing and evaluating the earning power and growth prospects of the company. Companies which are more forthcoming with disclosure may have a greater following by analysts, with more consensus among analysts' earnings forecasts, more accurate forecasts and less variable forecast revisions.<sup>87</sup> In these situations, the investor will be in a better position to judge the performance of management.

The interests of the investor may clash with the interests of management. The main interest of management is the success of and the survival of the business based on profit, followed by the wish to maximize personal income and management benefits. Management will be concerned about self-protection and potentially furthering self-interest. Management may want to release different information to what company outsiders may want to see. Management wants to promote a good public image for the company (for example, through community projects) with a view to increasing company profits.

Management controls the company on a daily basis and has open access to all the company's information in order to be in a position to react quickly and to provide disclosure.

### 2.5.2.3 Differential Disclosure: *Beaver*

Differential disclosure recognizes the information needs of retail and professional investors by separating the disclosure standards. *Beaver* advances two different disclosure standards for public disclosures—a short and simple disclosure one for the retail investor and a higher standard for the professional investor<sup>88</sup>—on the basis that very few investors, and certainly few retail investors, do not read the published accounting figures of companies. This would fulfil the ECMH,<sup>89</sup> so that market prices would still reflect all available information, professional investors and analysts will have access to full information, with a small release for the nonprofessional investor.

---

<sup>87</sup> Lang and Lundholm (1996), p. 467.

<sup>88</sup> Beaver (1978), pp. 44 and 50.

<sup>89</sup> Section 2.1.3, discussed above.

There are gaps in mandatory disclosure, which could be reinforced with the principles-based statement with an ethical and public interest tone that this book recommends—like a prohibition of misleading or deceptive conduct.

### ***2.5.3 The Third Problem of Mandatory Disclosure: How to Promote Information and Facilitate Disclosure?***

A market which is not fully informed will lose the confidence of those who use it. The regulation of financial services markets must face the question of how can the information be made available, and how can people have access to it. How can a company promote information by releasing details of sales, prices, quotations, company reports and other material information? What incentives are there to promote the disclosure of information?

Management will want to release good news, but beyond that disclosure regulations contain few and inadequate incentives to disclose beyond sanctions spread over many different areas of law. An important theme of securities regulation is how to bring about the disclosure of information, such as disclosure to shareholders, creditors, commissions and the stock exchanges. The stock exchange listing rules also require the maintenance of an informed market, with notification to the stock exchange required to avoid a false market (also referred to as self-regulation).<sup>90</sup>

But even with this disclosure, there may remain the problem that public does not understand the material. For example, Jin and Leslie examined the effect of a policy which required provision of information to consumers. Restaurants in Los Angeles County were regularly inspected and their hygiene conditions were rated. The ratings were not widely known until amendments were made which required restaurants to post their ratings on the door. When the public could see the inspection results in the hygiene quality grade cards on display, restaurant hygiene improved and consumers in turn become more sensitive to restaurants' hygiene quality.<sup>91</sup>

The ECMH assumes the rational investor and does not take into account irrational decisions. For example, in recent times investors 'were falling over themselves to get the (Firepower magic fuel pill) shares ... (and front-office staff) witnessed firsthand the frenzied buying'.<sup>92</sup> Walker calls for a return to behavioural finance and the 'legal genealogy' of disclosure regulation to recognize the prevention of fraud and investor protection to protect sometimes irrational investors from themselves.<sup>93</sup>

---

<sup>90</sup> Considered further in Chap. 7.

<sup>91</sup> Jin and Leslie and Fishman and Hagert (2003), p. 45.

<sup>92</sup> Gerard Ryle (2009), p. 239.

<sup>93</sup> Walker (2006).

In relation to company reporting, the following is needed for an informed market<sup>94</sup>:

- accurate reports—reports with errors may damage investor confidence and create false markets;
- timely reports—these must be released to the market immediately reliable figures are available. The stock exchanges must set absolute deadlines for the release of company reports, and
- meaningful reports—these must be clear and concise. Statements about current or future profitability should be capable of meaningful interpretation.

Selective disclosure in company briefings is not considered to be disclosure to the market. Selective company briefings could amount to insider trading. What is needed is open access for investors to major company briefings similar to Regulation Fair Disclosure in the United States (Reg FD, 2000) which limits the chance to leak good news and limits private disclosure—broader disclosure levels the playing field with respect to good and bad news. North shows that all investors need equal access to information and that they are not protected from selective disclosure to professionals by market efficiency.<sup>95</sup> The information provided at these briefings can be easily and cheaply disseminated to all stakeholders using webcasting and teleconference calls. North also shows most companies use public briefings.<sup>96</sup>

Regulators try to facilitate online (electronic) financial services disclosure in a technologically neutral environment.<sup>97</sup> The internet continues to empower stakeholders who have increasing access to increased amounts of information. Electronic commerce has and will continue to change the relationship between broker and client/investor. Increasingly, individuals manage their own investments and access material direct from brokers and company websites, information such as research materials and financial data, which was formerly only available to the industry. Financial regulatory issues which arise as investors continue to source information from many sources include how good are the sources of information, and how important is the need for investor education.<sup>98</sup> But the various benefits arising from technological advances should not overshadow the risks that these innovations pose to the efficiency and integrity of markets.<sup>99</sup> These changes raise issues that should be addressed by regulators in order to maintain the integrity of financial markets, in particular in respect of electronic disclosure.

Pioneering earlier commentary<sup>100</sup> on the value of electronic disclosure by means of the posting of the information on the issuer's website has the potential to

---

<sup>94</sup> Tricks (1982), p. 538.

<sup>95</sup> North (2008), p. 501; North (2009), p. 143.

<sup>96</sup> North (2008), p. 501.

<sup>97</sup> See IOSCO Technical Committee (2011), p. 7.

<sup>98</sup> Kingsford Smith and Williamson (2004).

<sup>99</sup> IOSCO Technical Committee (2011), p. 7.

<sup>100</sup> McGregor-Lowndes (1996), p. 219; Boros (1999), p. 522.

significantly reduce the informational disadvantage that individual investors face, and therefore to enhance confidence in the securities markets. This means more accessible and meaningful information disclosure to investors by means of web-based delivery and locating disclosures in one place on ‘one-click’ full access. At present there is fragmentation of electronic disclosure, which provides a barrier to accessible disclosure and there is a need to centralize information. Hyper-links to information from a central access point can enhance disclosure. Commissions should consider how to move disclosure into a system which takes full advantage of technical developments.<sup>101</sup> It remains important for regulators to be able to monitor e-disclosure, including the timing and method of delivery by e-disclosers. The Canadian Task Force, for example, recommended that Canada should take the leap to an ‘access equals delivery’ system of information delivery<sup>102</sup>—that posting a document on the commission website would satisfy filing and delivery requirements. The Task Force called its proposal ‘MERIT’—Model for Effective Regulatory Information Transfer, and MERIT does away with limited paper disclosure. Increasingly, investors have computer access at home,<sup>103</sup> however, increased web accessibility does not improve access to disclosures if there is fragmentation of the delivery of disclosure.

### Conclusion

Laying the foundation of this analysis of mandatory disclosure should naturally build on ethical standards, which should underpin the regulation of financial markets by commissions and stock exchanges (and by industry self-regulation). A book on disclosure must promote ethical values as a source of disclosure. Good ethics and good financial regulation have a unity of purpose in addressing the common problem of non-disclosure.<sup>104</sup>

This chapter has analysed some of the problems with achieving disclosure. Voluntary disclosure is likely to be limited by self-interest. Mandatory disclosure may achieve disclosure, but at what level of compliance. As a minimum, it requires enforcement by the commission and stock exchange by way of coregulation.

This chapter has concluded that disclosure laws are not fair to stock exchange stakeholders, including governments and regulators, who are being misled by the consequences of the overlapping diversity of disclosure

(continued)

<sup>101</sup> Sarra (2006), pp. 10, 13, 14, 137 and 138.

<sup>102</sup> Task Force to Modernize Securities Legislation in Canada, Final Report (Toronto, 2006), Recommendation 13, 59–62.

<sup>103</sup> On average, 34 % of the world population have home internet access. For example, 28 % in Asia, 68 % in Australia, 63 % in Europe and 79 % in North America (June 2012). See <http://www.internetworldstats.com/stats.htm>. Accessed 10 June 2014.

<sup>104</sup> See, e.g., Sappideen (1997), p. 422.



laws. Despite all of the theoretical debates, the reality of the law concerning disclosure is that there is an overlapping mix of common law, legislation and commission and stock exchange regulatory materials which allow disclosure in some instances and which deny it in others. Courts rarely cite economic theory on disclosure, and prefer legal analysis. Courts may order disclosure, but rarely on policy grounds. Both the common law, equity and legislation have evolved piecemeal to deal with emerging situations and are frequently inconsistent. This is not surprising given the lack of a consistent theoretical basis for disclosure.

The following four chapters will consider the particular types of enforcement of disclosure. Chapter 3 outlines corporate regulation and how disclosure fits into it. Chapter 4 examines disclosure at common law and in equity. Chapter 5 analyses the effectiveness of disclosure under the authority of the securities regulator. Chapter 6 examines the failings of self-regulation by stock exchanges. Each will be analysed against the policy and theoretical considerations discussed in this chapter. It will be seen that the law in each of these respects remains unsettled, difficult to apply, frequently inconsistent and lacking in theoretical justification.

## References

- Akerlof, George, The Market for Lemons: Quality Uncertainty and the Market Mechanism (1970) 84 *Quarterly Journal of Economics* 488
- Australian Competition and Consumer Commission, *ACCC Immunity Policy for Cartel Conduct* (2009). [www.accc.gov.au](http://www.accc.gov.au). Accessed 10 June 2014
- Baxt, Robert, Company Law and Securities (editorial) (2004) 32 *Australian Business Law Review* 290
- Beaver, William H., Current Trends in Corporate Disclosure (1978) 1 *The Journal of Accountancy* 44
- Beaver, William H., Market Efficiency (1981) 56 *Accounting Review* 23
- Benjamin, Joanna, *Financial Law* (Oxford University Press, Oxford, 2007)
- Berle, Adolf and Means, Gardiner, *The Modern Corporation and Private Property* (Macmillan, London, 1932)
- Black, Bernard, The Legal and Institutional Preconditions for Strong Securities Markets (2001) 48 *UCLA Law Review* 781
- Black, Julia, Empirical Legal Studies in Financial Markets: What Have We Learned? (Social Science Research Network Working Paper Series, 13 February 2010). <http://www.citeulike.org/user/EPSchuster/article/7227073>. Accessed 10 June 2014
- Bhattacharya, Utpal and Daouk, Hazem, The World Price of Insider Trading (2002) 57 *Journal of Finance* 75
- Bhattacharya, Utpal and Daouk, Hazem, When No Law is Better than a Good Law (2009) 13 *Review of Finance* 577
- Blair, Mark, and Ramsay, Ian, Mandatory Corporate Disclosure Rules and Securities Regulation, chapter 3 in: Walker, Gordon, Fisse, Brent and Ramsay, Ian (eds), *Securities Regulation in Australia and New Zealand* (LBC, North Ryde, 2nd ed, 1998) 55
- Boros, Elizabeth, Disclosure of Information on Company Websites (1999) 17 *Company and Securities Law Journal* 522

- Botosan, Christine, Evidence That Greater Disclosure Lowers the Cost of Capital (2000) 12 *Journal of Applied Corporate Finance* 60
- Brown, Philip, Taylor, Stephen and Walter, Terry, *The Effect of the Enhanced Disclosure Regime on the Efficiency of the Australian Share Market* (ASC commissioned report, Department of Accounting, University of Sydney, May 1996)
- Brown, Philip, Taylor, Stephen and Walter, Terry, The Impact of Statutory Sanctions on the Level and Information Content of Voluntary Corporate Disclosure (1999) 35 *Abacus* 138
- Capital Market Authority, Saudi Arabia, *Annual Report 2012* (Riyadh, 2013). <http://www.cma.org.sa/En/Pages/home.aspx>. Accessed 10 June 2014
- Carlin, Tyrone, Forensic Analysis of Failed Continuous Disclosure in Action (MGSM Working Paper No. 2006-15, Sydney, November 2006)
- Cassidy, Andrew and Chapple, Larelle, Australia's Corporate Disclosure Regime: Lessons from the US model (2003) 15 *Australian Journal of Corporate Law* 81
- Corbett, Angus, Self-Regulation, CLERP and Financial Markets: A Missed Opportunity for Innovative Regulatory Reform (1999) 22 *University of New South Wales Law Journal* 506
- Coffee, John, Market Failure and the Economic Case for a Mandatory Disclosure System (1984) 70 *Virginia Law Review* 717
- Coffee, John, Brave New World? The Impact(s) of the Internet on Modern Securities Regulation (1997) 52 *Business Lawyer* 1195
- Coffee, John and Sale, Hillary, Redesigning the SEC: Does the Treasury Have a Better Idea? (2009) 95 *Virginia Law Review* 707
- Coffee, John and Sale, Hillary, *Securities Regulation – Cases and Materials* (Foundation Press, New York, 12th ed, 2012)
- Coffey, Josephine, Enforcement of Continuous Disclosure in the Australian Stock Market (2007) 20 *Australian Journal of Corporate Law* 301
- Cox, James, Coping in a Global Marketplace: Survival Strategies for a 75-Year-old SEC (2009) 95 *Virginia Law Review* 941
- Donald, Christopher, A Critique of Arguments for Mandatory Continuous Disclosure (1999) 62 *Saskatchewan Law Review* 85
- Easterbrook, Frank and Fischel, Daniel, Mandatory Disclosure and the Protection of Investors (1984) 70 *Virginia Law Review* 669
- Easterbrook, Frank and Fischel, Daniel, *The Economic Structure of Corporate Law* (Harvard University Press, Cambridge MA, 1991), 290
- Fama, Eugene, Efficient Capital Markets: A Review of Theory and Empirical Work (1970) 25 *Journal of Finance* 383
- Ferrell, Allen, The Case for Mandatory Disclosure in Securities Regulation Around the World (2007) 2 *Brooklyn Journal of Business Law* 81
- Fishman, Michael and Hagert, Kathleen, Mandatory versus Voluntary Disclosure in Markets with Informed and Uninformed Customers (2003) 19 *Journal of Law, Economics, and Organization* 45
- Foster, George, *Financial Statement Analysis* (Prentice Hall, New Jersey, 2nd ed, 1986)
- Fox, Merritt B., Retaining Mandatory Securities Disclosure: Why Issuer Choice is Not Investor Empowerment (1999) 85 *Virginia Law Review* 1335
- Fraser, Steven, *Wall Street – America's Dream Palace* (Yale University Press, New Haven, 2008)
- Gerard, Ryle, *Firepower – The Most Spectacular Fraud in Australian History* (Allen and Unwin, Sydney, 2009)
- Gilson, Ronald, and Kraakman, Reinier, The Mechanisms of Market Efficiency (1984) 70 *Virginia Law Review* 549
- Golding, Greg, and Kalfus, Natalie, The Continuous Evolution of Australia's Continuous Disclosure Laws (2004) 22 *Company and Securities Law Journal* 385
- Gordon, Jeffery and Kornhauser, Lewis, Efficient Markets, Costly Information, and Securities Research (1985) 60 *New York University Law Review* 761

- Grover, Warren M.H. and Baillie, James C., Disclosure Requirements, in: Anisman, Philip et al (eds), *Proposals for a Securities Market Law for Canada* (Consumer and Corporate Affairs, Ottawa, 1979, Vol 3) 384
- International Organization of Securities Commissions Technical Committee, *Regulatory Issues Raised by the Impact of Technological Changes on Market Efficiency and Transparency* (July 2011). [www.iosco.org](http://www.iosco.org). Accessed 10 June 2014
- International Organization of Securities Commissions, *Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation* (September 2011). [www.iosco.org](http://www.iosco.org). Accessed 10 June 2014
- International Organization of Securities Commissions, *Objectives and Principles of Securities Regulation* (last revised June 2010). [www.iosco.org](http://www.iosco.org). Accessed 10 June 2014
- Jensen, Michael, The Performance of Mutual Funds in the Period 1945–1964 (1968) 23 *Journal of Finance* 389
- Jensen, Michael and Meckling, William, Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure (1976) 3 *Journal of Financial Economics* 305
- Jin, Ginger, and Leslie, Phillip, The Effect of Information on Product Quality: Evidence from Restaurant Hygiene Grade Cards (undated study), <http://are.berkeley.edu/~sberto/restaurants.pdf>. Accessed 10 June 2014
- Kahan, Marcel, Securities Law and the Social Costs of ‘Inaccurate’ Stock Prices (1994) 41 *Duke Law Journal* 977
- Kahan, Marcel, Some Problems with Stock Exchange-Based Securities Regulation (1997) 83 *Virginia Law Review* 1509
- Kitch, Edmund, The Theory and Practice of Securities Disclosure (1995) 61 *Brooklyn Law Review* 763
- Kingsford Smith, Dimity and Williamson, Kirsty, How Do Online Investors Seek Information, Theory, Method and Preliminary Findings (2004) 2 *Journal of Information, Law and Technology* (online)
- Kothari, S.P., Shu, Susan, and Wysocki, Peter, Do Managers Withhold Bad News? (MIT Sloan Research Paper No 4556-05, September 2009)
- La Porta, Rafael et al, Legal Determinants of External Finance (1997) 52 *Journal of Finance* 1131
- La Porta, Rafael et al, Law and Finance (1998) 106 *Journal of Political Economics* 1113
- La Porta, Rafael, Lopez-de-Silanes, Florencio, and Shleifer, Andrei, What Works in Securities Laws? (2006) 61 *Journal of Finance* 1
- Lang, Mark and Lundholm, Russell, Corporate Disclosure Policy and Analyst Behavior (1996) 71 *The Accounting Review* 467
- Langevoort, Donald, Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited (1992) *University of Pennsylvania Law Review* 851
- Langley, Rebecca, Over Three Years On: Time for Reconsideration of the Corporate Cop’s Power to Issue Infringement Notices for Breaches of Continuous Disclosure (2007) 25 *Company and Securities Law Journal* 439
- Macey, Jonathan, Administrative Agency Obsolescence and Interest Group Formation: A Case Study of the SEC at 60 (1994) 15 *Cardozo Law Review* 909
- Manela, Asaf, The Value of Diffusing Information (2014) 111 *Journal of Financial Economics* 181
- Mahoney, Paul, Is There a Cure for ‘Excessive’ Trading? (1995) 81 *Virginia Law Review* 713
- Mahoney, Paul, Mandatory Disclosure as a Solution to Agency Problems (1995) 62 *University of Chicago Law Review* 1047
- McGregor-Lowndes, Myles, Corporate Disclosure, the Internet and the Australian Securities Commission (1996) 14 *Company and Securities Law Journal* 219
- Meier-Schatz, Christian, Objectives of Financial Disclosure Regulation (1986) 8 *Journal of Comparative Business and Capital Market Law* 219
- Neagle, Anne-Marie and Tsykin, Natasha, ‘Please Explain’: *ASX Share Price Queries and the Australian Continuous Disclosure Regime* (Centre for Corporate Law and Securities Regulation, University of Melbourne, 2001)

- North, Gill, Closed and Private Company Briefings: Justifiable or Unfair? (2008) 26 *Company and Securities Law Journal* 501
- North, Gill, A Theoretical Basis for Selective Disclosure Regulation (2009) 32 *University of New South Wales Law Journal* 143.
- North, Gill, Periodic Disclosure Regulation: Enhancements to enable all Investors to Make Informed Decisions (2009) 27 *Company and Securities Law Journal* 23
- North, Gill, The Corporate Disclosure Co-regulatory Model: Dysfunctional and Rules in Limbo (2009) 37 *Australian Business Law Review* 75
- Ogus, Anthony, *Regulation – Legal Form and Economic Theory* (Hart Publishing, Oxford, 1994)
- Panel Discussion, Conflicts of Interest and the Regulations of Securities (1972–1973) 28 *Business Lawyer* 545
- Parker, Christine, The Emergence of the Australian Compliance Industry: Trends and Accomplishments (1999) 27 *Australian Business Law Review* 178
- Parker, Christine and Conolly, Olivia, Is There a Duty to Implement a Corporate Compliance System in Australian Law? (2002) 30 *Australian Business Law Review* 273
- Pauly, Mark and Nicholson, Sean, Adverse consequences of adverse selection (1999) 24 *Journal of Health Politics, Policy and Law* 921
- Pearson, Gail, The Ambit of Unconscionable Conduct in Relation to Financial services (2005) 23 *Company and Securities Law Journal* 105
- Phillips, Susan and Zecher, J. Richard, *The SEC and the Public Interest* (MIT Press, Cambridge MA, 1981)
- Reichel, Damian, Continuous Disclosure in Volatile Times (2010) 28 *Company and Securities Law Journal* 84
- Reyes, E. Richie, Can America Escape the Cloud of Corporate Corruption with the Sarbanes-Oxley Act of 2002 - A Proposal to Restore Efficiency and Integrity into the Capital Markets by Mandating Corporate Disclosures of Real-Time Information and Encouraging Investor Education (2002–2003) 24 *Hamline Journal of Public Law and Policy* 147
- Rogers, Jonathan, Skinner, Douglas, and van Buskirk, Andrew, Earnings Guidance and Market Uncertainty (2009) 48 *Journal of Accounting and Economics* 90
- Sale, Hillary and Fisch, Jill, The Securities Analyst as Agent: Rethinking the Regulation of Analysts (2003) 88 *Iowa Law Review* 1035
- Sappideen, Razeen, Motivations of Offeror Company Directors in Corporate Acquisitions (1987) 9 *University of Pennsylvania Journal of International Business Law* 67
- Sappideen, Razeen, Securities Market Efficiency Reconsidered (1988) 9 *University of Tasmania Law Review* 133
- Sappideen, Razeen, Economics, Law and Business Ethics: Some Reflections (1997) 25 *Australian Business Law Review* 422
- Sappideen, Razeen, The Paradox of Securities Markets Efficiency: Where to Next? (2009) *Singapore Journal of Legal Studies* 80
- Sarra, Janis, Modernizing Disclosure in Canadian Securities Law: An Assessment of Recent Developments in Canada and Selected Jurisdictions, in: Task Force to Modernize Securities Legislation in Canada, *Canada Steps Up* (Government of Ontario, Toronto, 2006)
- Shleifer, Andrei, *Inefficient Markets – An Introduction to Behavioural Finance* (Oxford University Press, New York, 2001)
- Skinner, Douglas, Why Firms Voluntarily Disclose Bad News (1994) 32 *Journal of Accounting Research* 38
- Smith, Adam, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776, E Cannan ed, 1937)
- Stern, Gary and Ron Feldman, Ron, *Too big to fail: the hazards of bank bailouts* (Brookings Institution Press, Washington DC, 2009)
- Thomas, Randall S., and Cotter, James F., Measuring securities market efficiency in the regulatory setting (2000) 63 *Law and Contemporary Problems* 105

- Tricks, D.V.C., Company Reporting: a Stock Exchange View, *The Australian Accountant*, September 1982, 538
- Walker, Gordon, Securities Regulation, Efficient Markets and Behavioural Finance: Reclaiming the Legal Genealogy (2006) 36 *Hong Kong Law Journal* 481
- Watts, Ross, Corporate Financial Statements, a Product of the Market and Political Processes (1977) 2 *Australian Journal of Management* 53

Promoting Information in the Marketplace for Financial  
Services

Financial Market Regulation and International  
Standards

Latimer, P.; Maume, P.

2015, XV, 238 p. 1 illus., Hardcover

ISBN: 978-3-319-09458-8