

Who Has Time to Read It Anyway?
Financial Markets Disclosure, Mum and Dad Investors and the
Theory of an Efficient Market.

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Introduction

When offering equity securities to the public, the issuer of the securities must disclose all material information relating to the investment to prospective investors.¹ This paper explores the ways in which this information influences the equity securities market, as well as investor behaviour, with the task of depicting the underlying goals behind mandatory disclosure. After concluding what the underlying goals of disclosure are likely to be, this paper will investigate how the law should formulate disclosure requirements to best achieve these goals, particularly in light of the evolving nature of market participants.

¹ Financial Markets Conduct Act 2013, s 39.

I Chapter I – The Challenge of Regulating for the Retail Investor

A The Rise of the Retail Investor

Globally, the number of non-institutional/individual investors (retail investors) has surged.² Financial markets have increasingly become necessary for the savings of everyday citizens, making it more of a mass market activity, and less of a speculative wealth accumulation activity performed exclusively by wealthy participants.³ Part of the reason for this is the decline in state funded pensions, as well as the evolving population demographics, and thus a greater level of individual responsibility taken for one's own savings.⁴ New Zealand has seen much of this growth through Kiwisaver rather than retail investors acquiring individual shares,⁵ and although New Zealand has not abandoned its comprehensive state funded pension, Statistics New Zealand projects that by 2068 – about the time people entering the workforce now will be retiring – there will be 2.1 people aged between 15 and 64 for each person aged 65 and above.⁶ A similar projection has been made for Europe.⁷ There has also been growth in the United States, but retail investor's behaviour has moved away from the equity securities market, and towards managed fund products.⁸ Therefore, at least for the generation entering the workforce now, individual savings are likely to be crucial to financial independence in retirement.

Research conducted by the Commission for Financial Capability in 2014 found that 19% of New Zealanders surveyed were investing in shares, and 21% have money in a unit trust or managed fund.⁹ At the same time, 15% were investing in some other way, 30% had money in a term deposit and 52% were contributing to Kiwisaver.¹⁰ At the end of 2016, New Zealand retail investors made up 23.2% of the ownership of NZX primary listed stocks, with a further

² Niamh Moloney "Regulating the Retail Market" in Niamh Moloney and Eilís Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (Oxford University Press, Oxford, 2015) 736 at 742-743.

³ At 742-743.

⁴ At 742-743; Lachlan Burn "Kiss, but Tell All: Short-form Disclosure for Retail Investors" (2010) 5(2) CMLJ 141 at 142-143.

⁵ See JBWere *Foreign Ownership Survey New Zealand 2016* (5 December 2016) at 2.

⁶ Statistics New Zealand *National Population Projections: 2014(base)-2068* (28 November 2014).

⁷ Burn, above n 4, at 142.

⁸ Donald C Langevoort "The SEC, retail investors, and the institutionalism of the Capital Markets" (2009) 95 Va Law Rev 1025 at 1026, 1030.

⁹ This figure excludes shares in one's own company; Commission for Financial Capability *2013 Financial Knowledge and Behaviour Survey: Full report* (11th June 2013) at 149, 166.

¹⁰ At 149, 166.

21.5% owned by New Zealand based managed funds.¹¹ These figures have remained relatively steady over the past decade, with the biggest growth being in managed funds.¹²

B The Need for Confidence in Financial Markets

Financial markets advance allocative efficiency in an economy by, in theory, allowing the most efficient users of capital to obtain capital from the public.¹³ This allows good firms to continue to grow, to invest in research and development, and to in turn benefit the economy as a whole.¹⁴ Strong capital markets facilitate economic growth.¹⁵ Retail investors with long-term savings goals are especially valuable as they are naturally more likely to support long-term growth strategies which give firms capital to expand and provide greater returns over time.

However, with retail investors in charge of their own savings, they have the choice whether they will participate in financial markets, or in alternatives like real property. In 2014, 20% of participants surveyed by the Commission for Financial Capability were investing in real property.¹⁶ Retail investors will only put their savings into financial markets if they have confidence in the market.¹⁷ The recent collapse of finance companies, and high profile initial public offerings (IPOs) which sharply declined in value have undoubtedly been damaging to this confidence. In recent years, the number of significant New Zealand equity security IPOs has been shrinking, having reached a high of 12 in 2014, both 2015 and 2016 saw only three, and projections have 2017 seeing a similar number, suggesting three per year may be the “new normal”.¹⁸ This is only a fraction of the 94 IPOs which occurred in Australia last year, even accounting for population differences.¹⁹ New Zealand also has a significantly lower market capitalisation relative to GDP when compared to other western economies.²⁰ If New Zealand investors do not have the confidence in capital markets that is needed to invest, firms will not

¹¹ JBWere, above n 5, at 2.

¹² At 2.

¹³ John C Coffee "Market failure and the case for a mandatory disclosure system" (1984) 70 Va L Rev 717 at 734-735; Luca Enriques and Sergio Gilotta "Disclosure and Financial Market Regulation" in Niamh Moloney and Eilís Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (Oxford University Press, Oxford, 2015) 511 at 519.

¹⁴ Iris Claus and Veronica Jacobsen and Brock Jera "Financial Systems and Economic Growth: An evaluation framework for policy" (New Zealand Treasury Working Paper, September 2004) at 6-7, 12.

¹⁵ Bernard Black "The Legal and Institutional Preconditions for Strong Capital Markets" (2001) 48(4) UCLA 781 at 782.

¹⁶ Commission for Financial Capability *Financial Behaviour Index Data, Wave 7* (November 2014) at 16.

¹⁷ Enriques and Gilotta, above n 13, at 514.

¹⁸ Chapman Tripp *New Zealand Equity Capital Markets Trends and Insights* (February 2017) at 4, 8; JBWere, above n 5, at 4.

¹⁹ *Deloitte 2017 IPO report: A game of snakes and ladders* (March 2017) at 3.

²⁰ JBWere, above n 5, at 4; New Zealand's market capitalisation is 41% of GDP, compared to Australia (88%), Canada (104%), the United Kingdom (115%), and the United States (122%).

list in New Zealand for fear of not being able to raise sufficient funds. This leads to profits from firms operating in New Zealand going overseas. To ensure the future participation of retail investors, and to assist them in receiving the best returns, and hence achieve financial independence in retirement, a strong capital market is essential.²¹

The withdrawal of investors tends to have a domino effect of lessening the liquidity of the market.²² Liquidity is a key determinant of whether a market is efficient,²³ and lower liquidity increases transaction costs, which increases the cost of capital and lessens the amount invested.²⁴ As transaction costs increase and trading becomes more difficult with lower liquidity, investors are less incentivised to participate in the market.²⁵ Therefore, maintaining the confidence of retail investors in the market so they continue to invest is crucial not just in growing their equity, but also to ensure New Zealand has a strong and efficient capital market.

C The Danger Posed by Information Asymmetries

An equity security is an artificial legal construct representing rights in an incorporeal legal entity.²⁶ Unlike tangible goods, investors cannot see, touch or test-drive an equity security. The value of an equity security depends on its future earning potential, which is dependent on the issuer's assets, industry position, business plans, past performance, management quality and many other factors.²⁷ The market relies on both the internal firm information available from disclosure, and external information relating to the market and economy as a whole, to value securities.²⁸ If investors do not have the relevant information, an information asymmetry arises. Information asymmetries incentivise sellers to supply inferior products, as they are able to obtain the same value no matter the actual quality of the security.²⁹ The practice of analysing the relevant information to be able to value an equity security to determine whether the offer price is a rational investment is complex and requires a dense level of financial skill and

²¹ Enriques and Gilotta, above n 13, at 514.

²² Marcel Kahan "Securities Laws and the Costs of 'inaccurate' stock price" (1992) 41 Duke LJ 977 at 1018-1019.

²³ Enriques and Gilotta, above n 13, at 519; Zohar Goshan and Gideon Parchomovsky "The Essential role of Securities Regulation" (2006) 55 Duke LR 711 at 714, 720.

²⁴ Kahan, above n 22, at 1020.

²⁵ At 1018-1019; Richard Deaves and Catherine Dine and William Horton "How are Investment Decisions Made?" in *Task Force to Modernize Securities Regulation in Canada: Research Studies volume 2* (2006) 239 at 264.

²⁶ Joanna Benjamin "The Narratives of Financial Law" (2010) 30 OJLS 787 at 788.

²⁷ Black, above n 15, at 782, 786; Goshan and Parchomovsky, above n 23, at 721.

²⁸ At 721.

²⁹ George Akerlof "The Market for 'Lemons': Quality, Uncertainty and the Market Mechanism" (1970) 84 QJ Econ 488 at 488.

knowledge.³⁰ Further, the information needs of retail and institutional investors are different. For example, research shows that the most important information to institutional investors is financial reports, whereas retail investors rely more on written narratives.³¹ The challenge for regulators is how, in this context, to ensure all market participants are able to get the information they need. If retail investors are intimidated by large disclosure documents, or make poor decisions due to misunderstanding and lose money, those retail investors, and anyone close to them, are likely to be dissuaded from investing in financial markets.³²

However, moves towards simplifying disclosure for the benefit of retail investors need to be balanced against the importance of making all information available in order to allow the market to function efficiently. An efficient market is often described as one where prices are accurate, liquidity is high, and price correction happens quickly.³³ This is more likely to occur when all the necessary information is easily accessible and understandable by market participants so that the price can quickly correct as investors try to profit from valuing securities above or below the current trading price.³⁴ Simplifying disclosure to the point that anyone, with no prior knowledge of financial markets, can understand it may require certain complex information to be omitted, especially when page limits are imposed.³⁵ If important information is not disclosed, there will be a greater friction between the value according to all the public information, and the actual underlying value of the security. If market values fail to represent their underlying value, investors will inevitably be paying too much or too little for a security, resulting in investors losing money and confidence in the financial markets, and good issuers unable to raise sufficient funds from the public market.

D The Role of Reputational Intermediaries

Even with disclosure requirements ensuring all material information is disclosed, financial markets still rely on trust. Investors cannot easily inspect a business venture to ensure the

³⁰ Kenneth B Firtel "Plain English: A reappraisal of the intended audience of disclosure under the Securities Act of 1933" (1999) 72 S Cal L Rev 851 at 864.

³¹ External Reporting Board *Information Needs of Users of New Zealand Capital Markets Entity Reports* (February 2016); H Kent Baker and John A Haslem "Information needs of individual investors" (1973) 136(5) *Journal of Accountancy* 64 at 68; Susan A Bartlett and Roy A Chandler "The corporate report and the private shareholder: Lee and Tweedie Twenty Years On" (1997) 29(3) *The British Accounting Review* 241 at 254; Chartered Financial Analyst *CFA UK annual survey on Financial Reporting and Analysis* (2015) at 3.

³² Ministry of Economic Development *Review of Securities Law Discussion Paper* (June 2010) at 76.

³³ Coffee, above n 13, at 734; Enriques and Gilotta, above n 13, at 519; Goshan and Parchomovsky, above n 23, at 714, 720.

³⁴ Coffee, above n 13, at 734; Enriques and Gilotta, above n 13, at 519; Goshan and Parchomovsky, above n 23, at 730.

³⁵ Firtel, above n 30, at 865.

accuracy of what is claimed in its disclosure and, in any case, most investors seek to obtain a passive income stream, not spend their capital investigating.³⁶ If all investors had to investigate, investors would duplicate one another's efforts.³⁷ Because new issuers, by definition, have not offered shares to the public before, investors are unlikely to have a record to know that the issuer can be trusted.³⁸ This inevitably heightens the risk of the investment and, as investors are generally risk averse, they will require greater reward for their capital.³⁹

This background encapsulates the role played by reputational intermediaries. Reputational intermediaries are the intermediate parties involved in financial markets, including accountants, lawyers and investment banks, which have long term reputational stakes in the market.⁴⁰ If an accounting firm misleads investors about the issuer's financial position, any one-time gain is likely to be outweighed by the reputational cost.⁴¹ Likewise, investment banks commonly inspect the issuer, and then put their money and reputation on the line making representations to potential investors.⁴² The financial adviser industry also plays an important role.⁴³

These reputational intermediaries perform a necessary role, particularly for retail investors who are incapable of undertaking their own investigations. Financial market regulation designed to protect retail investors ought to take account of the important role played by reputational intermediaries.

E The Paradoxical Concept of the Consumer Retail Investor

Another challenge for regulators is that retail investors fall into a peculiar position. Generally, everyday non-institutional parties are shielded from risk by consumer law, while the riskier, freedom-of-contract based dealing is reserved for commercial parties.⁴⁴ Thus, there is

³⁶ Frank H Easterbrook and Daniel R Fischel "Mandatory disclosure and the protection of investors" (1984) 70 Va L Rev 669 at 675.

³⁷ At 675.

³⁸ Black, above n 15, at 786.

³⁹ Kahan, above n 22, at 1025.

⁴⁰ Easterbrook and Fischel, above n 36, at 675; Black, above n 15, at 787.

⁴¹ At 675.

⁴² At 675.

⁴³ The regulation of financial advisers is currently being reviewed, see Ministry of Business, Innovation and Employment *Final Report: Review of the Operation of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008* (July 2016).

⁴⁴ Dimity Kingsford Smith and Olivia Dixon "The Consumer Interest and The Financial Markets" in Niamh Moloney and Eilis Ferran and Jennifer Payne (eds) *The Oxford Handbook of Financial Regulation* (Oxford University Press, Oxford, 2015) 695 at 696; In New Zealand consumers are protected by, among others, the Consumer Guarantees Act 1993, the Fair Trading Act 1986, the Credit Contract and Consumer Finance Act 2003, the Motor Vehicle Sales Act 2003, and the Minors' Contracts Act 1969.

undoubtedly a justification towards enacting financial market law that works as consumer protection law – to protect individual investors. However, financial markets operate by selling risk. Any attempt to turn financial markets law into consumer law to protect “consumer” retail investors has to deal with the paradox of removing risk while also retaining risk so that a profit can be made.⁴⁵ Hon David Thompson, in the second reading of the Securities Advertising Bill, captured this point perfectly by stating that “the purpose of the Bill is not to insure investors against loss. Risk is an inseparable part of an investment, and the Bill in no way attempts to alter that”.⁴⁶ Therefore, even if regulators decide that the purpose of financial markets law is to protect retail investors, it is not possible to remove all their risk, as their risk is exactly what is being bargained for. This creates yet another challenge in the task of designing effective modern financial markets law.

⁴⁵ At 697-698.

⁴⁶ (27 September 1978) 421 NZPD 3934; the Bill later became the Securities Act 1978, which was the predecessor of the Financial Markets Conduct Act 2013.

II Chapter II – The Regulatory Regimes

Over the past decade, regulators worldwide have been reforming their disclosure regimes to simplify them, with most of the focus being on managed funds. In recent years, New Zealand, Australia, Hong Kong, Singapore, Canada and the EU have all introduced a form of shortened disclosure (often a summary) for types of managed funds.⁴⁷ Managed funds are popular with retail investors, as professional managers invest their funds for them, and allow for much more diversified investments than if they were to invest in equity securities directly.

A Australia

In Australia, everyone must be enrolled in a superannuation scheme. This means most Australians are forced to become retail investors, so the case for making disclosure accessible is even more compelling. In 2010, Australia adopted a short-form disclosure, initially limited to six (but subsequently extended to eight) pages for superannuation, simple managed investment schemes, and standard margin lending facilities.⁴⁸

For offerings of equity securities, the firm issuing the securities (the issuer) has a choice. The regular requirement is for disclosure through a full prospectus, which is a principle-based disclosure document containing all the information that “investors and their professional advisers would reasonably require to make an informed assessment of the matters [required by the Corporations Act 2001]”.⁴⁹ However, issuers may opt to use a short-form prospectus, which must contain the same information as a prospectus, but can do so by incorporating information by reference to other documents.⁵⁰ The other documents must be made available on request to prospective investors.⁵¹ The reference must state if the information is primarily of interest to experts, or provide sufficient information to allow a person to whom the offer is made to decide whether or not to obtain a copy.⁵² The idea being that retail investors can read the short-form prospectus to understand the offer, and professional analysts can request extra information they

⁴⁷ Andrew Godwin and Ian Ramsay "Financial Products and short-form disclosure documents: A comparative analysis of six jurisdictions" (2015) CMLJ 10(2) 212.

⁴⁸ At 218; Corporations Act 2001 (Cth) s 1012B.

⁴⁹ Sections 710, 711.

⁵⁰ Section 712.

⁵¹ Sections 712, 705(2).

⁵² Section 712(2).

may need.⁵³ The prospectus must be aimed at investors and their professional advisers, and be worded in a “clear, concise and effective manner”.⁵⁴

Therefore, the Australian approach seems to be trying to get the best of both worlds with a tiered approach, by tailoring part of the disclosure towards retail investors, while retaining the broader requirements to ensure professional analysts may obtain all the information they need.

B The United States

The United States securities laws include a vast collection of legislation.⁵⁵ The primary legislation relating to disclosure is the Securities Act of 1933 (the 1933 Act), and the Securities Exchange Act of 1934 (the 1934 Act). The 1933 Act is primarily concerned with the initial offering of securities (the primary market), while the 1934 Act is focused on the trading of already issued securities (the secondary market), including continuous disclosure obligations.⁵⁶ The 1933 Act requires that investors are provided with a prospectus which contains information about the investment.⁵⁷ Under section 12 of the 1933 Act, a person is liable if they offer or sell securities using a prospectus that includes an untrue statement of a material fact, or omits a material fact.

Material fact is not defined in statute, but has developed a meaning from case law. Material facts are facts that “would have assumed actual significance in the deliberation of the reasonable shareholders”.⁵⁸ In *Basic v Levinson* the Supreme Court assumed the notional investor has a reasonable degree of sophistication, rejecting an argument that the issuer should not disclose early stage merger talks because investors might get confused and overestimate the probabilities.⁵⁹ Instead, the Court held “[d]isclosure, and not the paternalistic withholding of accurate information, is the policy chosen and expressed by congress”.⁶⁰ Further, “[t]he role of the materiality requirement is not to ‘attribute a child-like simplicity, an inability to grasp

⁵³ Australian Securities and Investments Commission *Regulatory Guide 254: Offering Securities Under a Disclosure Document* (March 2016) at rg254.37.

⁵⁴ Sections 710(1), 715A(1).

⁵⁵ The Securities and Exchanges Commission currently administers the Securities Act of 1933, the Securities Exchange Act of 1934, the Trust Indenture Act of 1939, the Investment Company Act of 1940, the Investment Advisers Act of 1940, the Securities Investor Protection Act of 1970, the Sarbanes-Oxley Act of 2002 and the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act; Louis Loss and Joel Seligman and Troy Paredes *Fundamentals of Securities Regulation* (6th ed, Wolters Kluwer Law & Business, New York, 2011) at 57.

⁵⁶ At 57-58.

⁵⁷ At 57-58; Securities Act 1933 ss 10, 12.

⁵⁸ *TSC Industries Inc v Northway Inc* 426 US 438 (1976) at 449.

⁵⁹ *Basic v Levinson* 485 US 224, 108 S Ct 978 (1988) at 985.

⁶⁰ At 985.

the problematic significance of negotiations”⁶¹. A Federal District Court stated that disclosure must be aimed at all audiences, including the amateur, the professional adviser who studies the disclosure closely, and the securities analyst who uses the prospectus as one of many sources in an independent investigation of the issuer.⁶² Thus “[t]he proper resolution of the various interests lies in the inclusion of a clearly written narrative statement outlining the major aspects of the offering and the particularly speculative elements, as well as detailed financial information which will have meaning only to the expert”⁶³. Therefore, in the United States, the target of disclosure is all audiences, and a reasonable degree of competence can be presumed.

In 1998, the Securities and Exchange Commission (SEC) amended disclosure rules by adding “plain English” requirements.⁶⁴ Rule 421(b) requires information in a prospectus to be presented in a “clear, concise, and understandable manner”⁶⁵. Specifically, the front and back cover pages, the summary, and the risk factors section of the prospectus must be written with plain English principles.⁶⁶ The principles include requirements for short sentences; definitive, concrete, everyday language; active voice; tabular presentation or bullet lists whenever possible; no legal jargon or highly technical business terms; and no multiple negatives.⁶⁷ Under Regulation S-K, a summary of information is required at the beginning of the prospectus where the length or complexity of the prospectus makes a summary useful.⁶⁸ The summary should provide a brief overview of the key aspects of the offering.⁶⁹ Where appropriate, another summary should also be made of the key risk factors.⁷⁰ Therefore, an effort has been made to provide for the informational needs of retail investors.

On the other hand, over the last two decades the SEC has also been focusing on the information needs of professional investors.⁷¹ The SEC has increased disclosure requirements to permit filings of projections, more detailed line-of-business data, and inflation accounting.⁷² It has also required management discussion and analysis of financial conditions and results of operations, and generally demanded increased disclosure of the risk factors.⁷³ The underlying theory being

⁶¹ At 985 citing *Flamm v Eberstadt* 814 F 2d (7th Cir 1987) at 1175.

⁶² *Feit v Leasco Data Processing Equipment Corp* 332 F Supp 544 (ED NY 1971) at 565-566.

⁶³ At 566.

⁶⁴ Loss and Seligman, above n 55, at 289.

⁶⁵ Code of Federal Regulations, title 17 § 230.421(b).

⁶⁶ Loss and Seligman, above n 55, at 289.

⁶⁷ § 230.421(d)(2).

⁶⁸ § 229.503(a).

⁶⁹ § 229.503(a).

⁷⁰ § 229.503(c).

⁷¹ Loss and Seligman, above n 55, at 291.

⁷² At 291.

⁷³ At 291.

that notwithstanding it being too difficult for most retail investors to understand, professional investors will be able to reflect the information in their valuations.⁷⁴ Therefore, the United States disclosure philosophy is to ensure access is available to all investors, while the need to simplify disclosure for retail investors does not override the information needs of professionals.

C New Zealand

New Zealand recently reformed its securities legislation by enacting the Financial Markets Conduct Act 2013 (FMC Act). In its discussion document on reforming securities law, the Ministry of Economic Development (Ministry) stated that the primary purpose of disclosure is to cure the information asymmetry between issuers and investors.⁷⁵ The Ministry considered allocative efficiency to be a secondary goal.⁷⁶ The discussion paper identified retail investors as the primary targets of disclosure, with disclosure ideally comprehensible to all retail investors, but where not possible, to the “prudent, non-expert retail investor”.⁷⁷ One of the Ministry’s main criticisms of the previous regime was that disclosure was complex and not understood by retail investors.⁷⁸

Under the FMC Act, every public offer of financial products must include a product disclosure statement (PDS), and usually must incorporate additional information via an online register.⁷⁹ Each PDS must begin with a key information summary (KIS) at the start of the PDS, which sets out the major aspects and risks of the financial product.⁸⁰ The purpose of the KIS is “to provide the issuer’s assessment of the most significant aspects of the offer of the financial products that are relevant to a prudent but non-expert person’s decision as to whether or not to acquire the financial products”.⁸¹ The KIS is subject to strict page and word limits and the permitted content is highly prescribed.⁸² The PDS for managed funds is relatively short, being limited to the highest of either 12 A4 pages or 6,000 words,⁸³ while the PDS for equity securities is longer, being 60 A4 pages or 30,000 words, but still much shorter than

⁷⁴ At 291.

⁷⁵ Ministry of Economic Development, above n 32, at 75.

⁷⁶ At 76.

⁷⁷ At 76.

⁷⁸ At 78.

⁷⁹ Financial Markets Conduct Act 2013, ss 39, 48, 57(1)(b). Under the statute, a register entry may not be required if all the material information is disclosed in the PDS and if the regulations do not require additional information. Under the current regulations, there are prescribed requirements for the register, so a register entry is required.

⁸⁰ Financial Markets Conduct Regulations 2013, reg 26(1).

⁸¹ Regulation 27(1).

⁸² Regulation 29; In the case of a managed fund, the KIS must be no longer than the highest of either 2 A4 pages or 1,000 words, and in the case of equity securities, 4 A4 pages or 2,000 words.

⁸³ Regulation 24(2).

prospectuses and investment statements would be under the former regime or in overseas jurisdictions.⁸⁴ At the beginning of an equity securities KIS a statement must be included explaining that ordinary shares are an ownership stake in the issuer, and profit can be made either through dividends or by selling the securities at a higher price, but there is a risk the investor may lose some or all of their invested money.⁸⁵ There is also a general requirement that all other “material information” must be disclosed on the register.⁸⁶ Additionally, the disclosure must be presented in a “clear, concise, and effective manner”.⁸⁷ Therefore, the FMC Act has undoubtedly attempted to keep the disclosure documents as retail investor friendly as possible.

Whether the FMC Act disclosure regime also caters for sophisticated investors and advisers is likely to depend on how the court interprets the intended audience of disclosure, and the meaning of material information. Who the intended audience is, is important because in *Houghton v Saunders* the Court of Appeal held whether a statement is misleading (and hence attracts liability) depends on whether it is misleading to the target audience.⁸⁸ The purpose of a PDS is “to provide certain information that is likely to assist a prudent but non-expert person to decide whether or not to acquire the financial products”.⁸⁹ Thus, on its face, only information in a form readily comprehensible by prudent non-experts would be relevant in the PDS. This has the consequence that complex financial data which would not be properly understood by non-experts, and hence would not assist their decision, is not required – even if it is relevant to a rational investment decision. Under the previous (Securities Act 1978) regime, the Court of Appeal avoided this result by holding that a prudent non-expert would consult an expert on matters which they do not understand.⁹⁰ The Court relied on the fact that investment statements had to prominently include a statement telling the investor to “Ask questions. Seek Advice.”⁹¹ However, under the Financial Markets Conduct Act Regulations (FMC Regulations), the analogous mandatory statement now only requires a paragraph that ends with “You can also seek advice from a financial adviser to help you make an investment decision”, suggesting

⁸⁴ Regulations 23(2), 49G.

⁸⁵ Schedule 3, reg 5.

⁸⁶ Regulation 42(a); Financial Markets Conduct Act s 57(1)(b)(ii).

⁸⁷ Section 61(1).

⁸⁸ *Houghton v Saunders* [2016] NZCA 493 at [74].

⁸⁹ Financial Markets Conduct Act, s 49.

⁹⁰ *Houghton v Sanders*, above n 88, at [78].

⁹¹ At [79]; Investment statements were the primary disclosure document (similar to a Product Disclosure Statement) that had to be distributed with offers made under the Securities Act 1978, which preceded the Financial Markets Conduct Act 2013; Securities Act 1978, ss 38C-38F.

advisers are only optional and the PDS can still be read without them.⁹² In any case, the wording is not as strong as it was under the Securities Act. It is difficult to see how the court will read in that the PDS is also targeted at professional advisers when the PDS itself suggests advisers are only an optional aid. It is also worth noting that the legislature chose not to adopt the Australian wording of “prudent investors *and their professional advisers*”.⁹³ The Ministry discussion document stated the aim of disclosure was to inform all retail investors, and made no mention of it being to inform their advisers.⁹⁴ Therefore, in contrast to the Australian and United States regimes, it is arguable that the information needs of sophisticated investors and advisers are not catered for in the primary disclosure document.

The statute does not expressly state the target audience of documents on the register. However, it does require that all other “material information” must be disclosed on the register, so if complex financial data is “material information”, it will presumably need disclosed on the register.⁹⁵ Material information is defined as information that “a reasonable person would expect to, or be likely to, influence persons who commonly invest in financial products in deciding whether to acquire the financial products on offer”.⁹⁶ The Ministry’s view has been that this definition requires broader information than is needed by the “prudent non-expert”.⁹⁷ However, such a definition is troubling as it also does not seem to include the information needs of sophisticated investors. Although “persons who commonly invest” may encapsulate both retail and sophisticated investors, the idea a “reasonable person” has of the information likely to influence market participants probably mirrors the idea prudent non-experts would have, which is likely to include some information that is not relevant to a rational investment decision, and exclude some information that is. This is because a reasonable person who is not sophisticated in financial markets is unlikely to know what information will influence sophisticated investors. Therefore, the requirement to include all material information may not be enough to ensure the information needs of sophisticated investors are satisfied.

⁹² Financial Market Regulations, reg 20(1)(e).

⁹³ Corporations Act s 710(1) (emphasis added).

⁹⁴ Ministry of Economic Development, above n 32, at 76.

⁹⁵ Section 57(1)(b)(ii).

⁹⁶ Section 59(1).

⁹⁷ In the Ministry’s draft bill submissions review, in response to a submission that “prudent non-investor” and “person who commonly invests in shares” should be changed to be the same standard, the Ministry’s comment was that this would not be adopted as it would require a wider set of information to be included in the PDS; Ministry for Economic Development *Financial Markets Conduct Bill Exposure Draft: Table of submissions and Ministry comments* (October 2011) at 61.

Further, in *R v Moses* (decided under the Securities Act) the High Court determined that prospectuses must be aimed at non-experts, because the legislation expressly stated investment statements (which were a separate document, analogous to a PDS) were targeted at non-experts.⁹⁸ The reasoning for this was that since investment statements could refer to information in the prospectus, the prospectus should have to be written with the same audience in mind.⁹⁹ On the other hand, it could probably be argued that the omission of an express target audience for the register in the FMC Act meant that it was intended to appease all audiences. It is also arguable that the prospectus is an entirely different concept to the register altogether, with the prospectus being a narrative offer document, while the register is a place the issuer can upload relevant documents. For example, the company's constitution and material contracts must be uploaded to the register, neither of which are likely to be understandable by, and thus likely to influence, prudent non-experts.¹⁰⁰ The regulations also require documents, like group financial statements, that are likely to be only useful to sophisticated investors, to be uploaded to the register.¹⁰¹ Thus, information needs of sophisticated investors may be catered for where expressly prescribed in the regulations, but an argument can still be made that the general requirement to include all other material information will not encapsulate relevant specialist-specific information.

Therefore, New Zealand's approach appears targeted primarily at the information needs of prudent non-experts. It is also arguable that this is reminiscent of a tiered approach, because of the additional information to be available on the register, and the potentially broader interpretation that prudent non-experts would consult professional advisers. However, New Zealand's disclosure regime does not seem to have the same focus on providing for the informational needs of sophisticated investors as the Australian or the United States regimes

D Conclusion of the Regulatory Responses

In all the jurisdictions discussed, the regimes aim to ensure unsophisticated investors are able to understand at least some of the disclosure documents. In Australia and (arguably) New Zealand this is achieved with a tiered regime, where some forms of the disclosure are clearly aimed at unsophisticated investors, while it could be argued other required disclosure is aimed more at professionals. The United States simply requires disclosure which has elements clearly

⁹⁸ *R v Moses* HC Auckland CRI-2009-004-1388 8 July 2011 at [63]; Securities Act 1978, s 38D.

⁹⁹ At [63].

¹⁰⁰ Financial Markets Conduct Regulations, reg 54.

¹⁰¹ Regulation 53.

aimed at unsophisticated investors, while including requirements for information only useful to professional investors. New Zealand seems to be the most concerned with informing unsophisticated investors, while also being the least concerned with informing professional investors.

III Chapter III – The Underlying Purposes and Goals Behind Disclosure

Both what the dominant purposes of disclosure are (and financial market regulation as a whole), and what the purposes ought to be, are contestable. The question also has practical relevance for disclosure, because before it can be argued who disclosure should be targeted towards, it is important to find the underlying purposes of disclosure. Four of the most prominently argued theories are:

- a. Disclosure is about informing investors in order to protect them. Under this approach, financial market regulation is a form of consumer protection.¹⁰²
- b. Disclosure is required to maintain the confidence of the investing public. If investors do not have confidence, they will not invest, and there will not be public financial markets.¹⁰³
- c. Disclosure is necessary to reduce agency costs and combat fraud. Disclosure makes it more difficult for management to breach their duties and to engage in suspect related-party transactions.¹⁰⁴
- d. Disclosure is required to ensure accurate prices and a strong and efficient capital market. Disclosure subsidises information traders by making information more readily available, allowing for more accurate and timely corrections of price, leading to better allocative efficiency, a stronger capital market, and protection of investors by ensuring they will pay a fair price.¹⁰⁵

It is likely that disclosure reflects each of the above purposes to a degree, but if one is dominant, disclosure ought to be crafted to best achieve the dominant goal. This chapter will discuss the competing narratives and analyse whether disclosure actually promotes that purpose. As part of this analysis, this paper will explore how investors and the market actually utilise the information obtained from disclosure.

¹⁰² *Houghton v Saunders*, above n 88, at [45]; *Hickman v Turn and Wave Ltd* [2012] NZSC 72, [2013] NZLR 741 at [41]-[46]; Enriques and Gilotta, above n 13, at 514; Benjamin, above n 26, at 794-795.

¹⁰³ Ministry of Economic Development, above n 32, at 76; Enriques and Gilotta, above n 13, at 514.

¹⁰⁴ Paul G Mahoney "Mandatory Disclosure as a Solution to Agency Problems" (1995) 62 U Chi L Rev 1047 at 1048; Enriques and Gilotta, above n 13, at 516-517.

¹⁰⁵ Mahoney, above n 104, at 1047-1048; Goshan and Parchomovsky, above n 23, at 714, 720; Eugene Fama "Efficient Capital Markets: A review of Theory and Empirical Work" (1970) 25 Journal of Finance 383 at 383; Enriques and Gilotta, above n 13, at 519.

A *Protecting Investors*

This purpose fulfils a persuasive legal narrative. As discussed in chapter I, since equity securities are intangible, a purchaser cannot know what they are buying without information. The purchase of an equity security is essentially the purchase of risk. The investor invests capital in exchange for the chance that the equity security will return dividends and/or increase in value. The risk is that the securities may not pay dividends and may decline in value. To properly consent to the risk and be held to their bargain, financial markets law requires that the purchaser is informed of the risks via disclosure.¹⁰⁶ In the same way a breach of warranty or a misrepresentation by an insurance policy holder may void the policy “because the insurer had only agreed to cover the risk provided the warranty was performed”, investors of securities should not be held to their investment if material information was not disclosed.¹⁰⁷ This in turn provides protection for the purchaser, as it ensures they are advised of all the risks. As retail investors are the least sophisticated type of investor, disclosure should be aimed towards them, as if a retail investor can understand the risks, all those more sophisticated than them ought to be able to as well.

Historically, this theory had wide acceptance. The first modern comprehensive securities legislation, the Securities Act of 1933, was passed in the United States during the New Deal Roosevelt presidency, and not long after the beginning of the great depression. It is unlikely the competing rationales of market efficiency or the reduction of agency costs were at the forefront of the legislators’ minds. The approach has also recently received judicial approval in New Zealand, with the Court of Appeal in *Houghton v Saunders* stating that the “legislation does not seek to limit the level of risk to which investors may be exposed, but rather to ensure that investors receive adequate and accurate information so that they are fully able fully to understand and evaluate the risks for themselves”.¹⁰⁸ Similarly, the Supreme Court in *Hickman v Turn and Wave* stated that the Securities Act is investor protection legislation designed to ameliorate the vulnerability of investors.¹⁰⁹ Notably, both judgments were made under the now repealed Securities Act 1978, which had no purpose section.

The FMC Act has several purpose sections including a primary purpose of promoting “the development of fair, efficient, and transparent financial markets” and an additional relevant

¹⁰⁶ Joanna Benjamin, above n 26, at 794-795.

¹⁰⁷ At 794; *HIH Casualty and General Insurance Ltd v New Hampshire Insurance Co and others* [2001] CLC 1480 (CA) at [124] per Rix LJ; Financial Markets Conduct Act, s 54.

¹⁰⁸ *Houghton v Saunders*, above n 88, at [45].

¹⁰⁹ *Hickman v Turn and Wave*, above n 102, at [41]-[46].

purpose of providing “timely, accurate, and understandable information ... to persons to assist those persons to make decisions relating to financial products”. Neither purpose section states that it refers specifically to disclosure, but it could probably be argued that both purposes apply to disclosure. In any case, the statutory purpose at least provides support for the premise that disclosure is about ensuring that investors are properly informed of the investment they are undertaking. As the FMC Act specifically directs disclosure towards retail investors, this further supports the argument that disclosure is about ensuring the protection of investors by ensuring all the information that may be relevant to their decision is disclosed to them.

However, the policy of targeting disclosure at all investors in order to protect them inevitably assumes that all investors, including retail investors, will read and comprehend the disclosure to make rational investment decisions. A Securities Commission proposal in 1980 cast serious doubt on that, stating “[o]ur view is that the potential investor should be told; it matters not that he does not understand”.¹¹⁰ But if a large number of retail investors do not read and comprehend disclosure documents, then the informed consent narrative cannot achieve its goal of protecting investors, nor are investors really consenting to their risks. This chapter will discuss why the assumption that retail investors read and understand disclosure, may not be accurate. The assumption may not be accurate because of the relevance of external information, the complexity of financial data, the possibility of information overload, and because retail investors are influenced by inherent biases and heuristics.

1 External information

To accurately value a security and understand the risks involved the investor must have regard to both internal firm information and external information, including knowledge of the industry, the economy and other available investment opportunities.¹¹¹ Internal firm information only paints one side of the picture and thus disclosure documents alone are insufficient to fully understand the investment decision. While disclosure does require the issuer to state the risks they face,¹¹² a prudent non-expert is unlikely to have the knowledge required to quantify these risks, or a running knowledge of the factors that are likely to influence this risk over time.¹¹³ Further, a rational investment decision cannot be made in isolation. The investor needs to compare the investment opportunity to the many other available

¹¹⁰ Securities Commission *Proposed Recommendations for Securities Regulation* (1980) at [3.3.6].

¹¹¹ Goshan and Parchomovsky, above n 23, at 721; Firtel, above n 30, at 867.

¹¹² Financial Markets Conduct Regulations, schedule 3, reg 42.

¹¹³ Firtel, above n 30, at 864.

investment opportunities, which would require a significant dedication of time and expertise, and it is probably unreasonable to expect any meaningful quantity of retail investors to do this.¹¹⁴ Therefore, if knowledge outside of just that contained in disclosure documents is required to be protected from risk and to make rational investment decisions, disclosure in itself is unlikely to succeed in its goal of protecting investors.

2 *Complexity of financial data*

European studies into the comprehension levels of investors show that there is a very low level of understanding among retail investors.¹¹⁵ This is particularly concerning in the New Zealand context where in the discussion document the stated aim of the PDS was to inform every type of retail investor (not just prudent ones).¹¹⁶ The need to include a statement explaining what an ordinary share is reinforces that the goal of informing every type of retail investor made it into the regulations, as prudent investors would surely know what an ordinary share is.¹¹⁷ An IFF Research and YouGov study in the European Union found that 42% of survey respondents erroneously believed that investments in corporate bonds meant that their capital was protected no matter what happened.¹¹⁸ Survey respondents were shown a prototype short form PDS relating to a managed fund, and then asked seven relatively elementary true or false questions relating to the investment.¹¹⁹ Only 2% of respondents got all seven correct, while only 12% got six or more.¹²⁰ The survey was conducted online, and all the respondents had recently invested in a managed fund or planned to do so in the near future.¹²¹ The mean number of correct responses was 3.5 – half the questions.¹²² However, research from the European Union may not directly translate to New Zealand. Surveys conducted by the Commission for Financial Capability found that New Zealanders have significantly higher levels of financial knowledge than the other countries surveyed, which included the United Kingdom, Germany, Ireland, and a separate survey which included Australia.¹²³ Nonetheless, the survey related to more general

¹¹⁴ At 876-868.

¹¹⁵ Burn, above n 4, at 159-160.

¹¹⁶ Ministry of Economic Development, above n 32, at 76.

¹¹⁷ See Financial Markets Conduct Regulations, schedule 3, reg 5.

¹¹⁸ IFF Research and YouGov *UCITS Disclosure Testing Research Report* (June 2009) at 42.

¹¹⁹ The questions were: The fund aims to achieve steadier returns than the Morgan Stanley Capital Investment Emerging Markets Index (MSCI)? The fund will always do better than the performance of the MSCI? The fund may invest in all types of bonds? The majority of the fund's assets must be invested in stocks but the remaining part may be invested in bonds? Because the fund invests in bonds 40% of my capital is protected no matter what happens? 100% of the fund may be invested in shares from emerging countries such as Brazil, Russia, and China? The fund can invest in bonds from any country?

¹²⁰ At 45.

¹²¹ At 7.

¹²² At 45.

¹²³ Commission for Financial Capability, above n 9, at 33, 37.

financial questions, such as how interest and inflation works, and even though New Zealand scored the highest, only 49% of respondents understood the concept of compound interest.¹²⁴ As discussed in chapter II, PDSs for equity securities must include an explanation that an ordinary share is a slice of ownership in the issuer, implicitly presuming that some investors do not yet know this. A critic could argue that this means the FMC Act is presuming investors could comprehend everything they need to know to make smart investment decisions immediately after they have only just learned what an ordinary share in a company is. If many retail investors do not have even an elementary level of the type of financial knowledge necessary to understand equity security disclosure documents, it is unlikely they are actually deriving any benefits from disclosure, least of all understanding and consenting to the risks.

The FMC Act attempts to cure this by requiring simple language and by enacting that the purpose of a PDS is to inform non-experts.¹²⁵ However, simplifying the presentation of complex financial concepts does not change that they are complex financial concepts.¹²⁶ Simplification also creates another risk. As discussed in chapter II, if disclosure is targeted only at non-experts, information which is relevant to the value and risks of an investment (such as complex accounting data and material contracts), but would never be understandable and thus not likely to “assist a prudent but non-expert person to decide whether or not to acquire the financial products” would seemingly be excluded.¹²⁷ Likewise, information that would influence an unsophisticated investor’s decision to invest, even though it may be an irrational basis to invest, would, on a literal interpretation, have to be included. An example of information which may influence retail investors but is not a good basis to make a decision may include information relating to historic past performance, which will be discussed in greater detail later in this chapter.¹²⁸ The end result being that simplifying disclosure will not assist unsophisticated investors in consenting to risk, because they may not be influenced by important information, but may be irrationally influenced by unhelpful information.¹²⁹

¹²⁴ At 33, 37.

¹²⁵ Financial Markets Conduct Act, ss 49, 61(1).

¹²⁶ Andrew Godwin and Paul Rogerson, "Clear, Concise and Effective: The Evolution of Product Disclosure Documents" in Shelley Griffiths, Sheelagh McCracken and Ann Wardrop (eds), *Exploring Tensions in Finance Law: Trans Tasman Insights* (Thomson Reuters, Wellington, 2014) 1 at 14; Firtel, above n 30, at 888-889; Burn, above n 4, at 160.

¹²⁷ Godwin and Rogerson, above n 126, at 22.

¹²⁸ See Deaves, above n 25, at 258-259.

¹²⁹ Goshan and Parchomovsky, above n 23, at 724; Enriques and Gilotta, above n 13, at 516.

3 *Information overload*

Aside from comprehension difficulties, retail investors are also at a greater risk of “information overload”. For someone unfamiliar in dealing with financial information, and with a finite amount of time, even 60 pages is a lot of information to take in. Research has shown that when people are given too much information, they start to simplify it in a way to use less cognitive effort, but this in turn means they make worse decisions.¹³⁰ Each investor only has so much time and cognitive capabilities, so they will rationally exclude parts of it.¹³¹ Retail investors are likely to have far less time than professional analysts to evaluate and understand the information, so they are more likely to be affected by information overload and consequently likely to make worse decisions. This also heightens the risk they will read the 4-page KIS and venture no further. Although information overload may influence all types of investors, professional analysts are more likely to be able to handle more information, and to know which information can be rationally excluded.¹³² If the quantity of information disclosed was lessened to lower the risk of information overload by retail investors (which was probably the intention behind the 60 page limit) this will lead to undesirable results for professional analysts, as their threshold for information will inevitably be higher, and so they will miss out on information they could have used.¹³³ Therefore, the do-it-yourself regulatory approach of giving retail investors entire disclosure documents to work out for themselves may actually be more harmful and mean that retail investors are not actually benefiting from disclosure.

4 *Biases and heuristics*

Individuals and their investment decisions are influenced in a misleading way by biases and heuristics.¹³⁴ This includes overoptimism, which involves overestimating one’s capabilities;¹³⁵ overconfidence, which involves overestimating one’s ability to predict outcomes;¹³⁶ egocentricism, which involves overstating the role that one has played in past events in which one has participated;¹³⁷ and hindsight bias, where one overstates the predictability of past

¹³⁰ Troy A Paredes “Blinded by the Light: Information Overload and its Consequences for Securities Regulation” (2003) 81 Wash ULQ 417 at 419; Enriques and Gilotta, above n 13, at 515.

¹³¹ Paredes, above n 130, at 435-436.

¹³² At 454.

¹³³ At 461.

¹³⁴ Jeffrey J Rachlinski “The Uncertain Psychological Case for Paternalism” (2003) 97 NWULR 1165 at 1172-1173; Turcan Ciprian and Turcan Radu and Dedu Vasile “Behavioral Biases in Trading Securities” (2010) 1(2) Annals of the University of Oradea: Economic Science 717; Hersh Shefrin *Beyond Greed and Fear: Understanding Behavioral Finance and the Psychology of Investing* (Oxford University Press, Oxford, 2002).

¹³⁵ Rachlinski, above n 134, at 1172.

¹³⁶ At 1172.

¹³⁷ At 1172.

events.¹³⁸ These have an influence on financial decisions.¹³⁹ Although heuristics can be beneficial, they may also lead us to too readily making decisions without logically testing them. This leads to investors being too willing to invest in risky ventures, and to mistakenly believe that past performance will continue unabated, rather than to make rational decisions aided by the relevant information.¹⁴⁰ An example of this was where survey participants were asked to allocate \$100,000 between two investments, where one (A) had an average return of 5% over the last 5 years, and the other (B) had an average return of 15% over the last 5 years and the participants were told that analysts had forecast that both A and B would return an average of 10% for the next 5 years.¹⁴¹ Since there were only two stocks, and they were likely to provide the same returns, the most rational investment would be to diversify by putting \$50,000 in each investment. However, 63.8% put more into A, and 11.6% put more into B. This demonstrates that even when investors have the right information, they can be influenced by biases, heuristics and irrelevant information to make irrational decisions.

Therefore, the narrative that disclosure is about ensuring informed consent to risk, although supported judicially and probably the original rationale, is not well supported by the evidence. If disclosure is not actually benefiting investors by giving them the information they need, the focus of targeting disclosure at retail investors may need to be adjusted to reflect the reality.

B Maintaining Investor Confidence.

Investors will only participate in financial markets if they have confidence in the markets.¹⁴² Without mandatory disclosure, there would be a perceived unfairness between the institutional investors, who have the resources and market power to obtain material information, and unsophisticated investors, who are likely to lack the resources, time, and market power to get an equal share of disclosure.¹⁴³ Under these conditions, it is less likely that retail investors will have the confidence to participate in the market.¹⁴⁴ Mandatory disclosure allows for a perceived fairness of information, as issuers have to disclose all material information to all investors.¹⁴⁵

This purpose may not be undermined as much by retail investors not actually understanding disclosure, as it is about ensuring a perceived fairness, rather than actual fairness. As long as

¹³⁸ At 1171-1172.

¹³⁹ At 1182-1183.

¹⁴⁰ At 1184-1185.

¹⁴¹ Deaves, above n 25, at 258-259.

¹⁴² Enriques and Gilotta, above n 13, at 514; Ministry of Economic Development, above n 32, at 76.

¹⁴³ Enriques and Gilotta, above n 13, at 515.

¹⁴⁴ At 514.

¹⁴⁵ At 514-515.

investors believe they are on an even playing field, their confidence is likely to improve. However, on the other side of the coin is the fact that if investors do not understand disclosure, and then come to irrational investment decisions, they will systematically lose out to more sophisticated investors. Any perceived fairness would quickly wear off when reality kicks in. It is also unattractive from a policy perspective to justify disclosure on the basis that it deceives retail investors into believing that they are on a level playing field so that they invest their money, when regulators know that they are not. This goal has apparently now also been discarded by many academic commentators.¹⁴⁶ Therefore, although disclosure may benefit this goal, it is unlikely to be the dominant purpose behind disclosure.

C Reducing Agency Costs

Agency costs are the economic costs of having “agents” work for you. A company is an incorporeal entity, so it must hire agents to run its business. The concept is broad and encapsulates all the costs relating to agency, including the costs of having agents with different incentives. Disclosure opens the curtains on an issuer’s business, including on the activities of management. Mandatory disclosure thus decreases the costs of monitoring the agents’ behaviour, which lowers the agency cost and thus lowers the firm’s cost of capital (as the cost of disclosure is offset by the reduction in agency costs).¹⁴⁷ Agency costs are further reduced by the fact that instead of just internal monitoring, every prospective investor and analyst will be able to inspect the activities of management, which will provide a significant deterrent and allow sanction for disloyalty and incompetence. At least one commentator has even argued the original United States securities Acts were not New Deal innovations, but evolved from the common law rules applicable to agents dealing adversely with their principals.¹⁴⁸

One benefit is that any disloyalty will be more easily discovered.¹⁴⁹ Disclosure acts as both a deterrent and a way of discovering prior breaches.¹⁵⁰ However, courts already can and do sanction breaches of the duty of loyalty, so the benefits in catching disloyal agents should not be overstated. Arguably, the greater benefit is that disclosure enables a sanction for breaching the duty of care.¹⁵¹ It has been alleged that the social cost of breaching the duty of care is much greater than the breach of loyalty.¹⁵² The problem is that courts are ill-equipped to adjudicate

¹⁴⁶ At 515.

¹⁴⁷ At 516; Mahoney, above n 104, at 1048.

¹⁴⁸ At 1049.

¹⁴⁹ At 1050; Enriques and Gilotta, above n 13, at 516-517.

¹⁵⁰ At 517-518.

¹⁵¹ Goshan and Parchomovsky, above n 23, at 717.

¹⁵² At 717.

on and sanction the competence of business decisions.¹⁵³ On the other hand, with professional analysts covering the issuer, poor business decisions are able to be sanctioned by the analyst's research report with a consequent lower valuation of that issuer.¹⁵⁴ This provides a greater incentive for firms to retain good management, and for management to continue to perform. A combination of accurate share prices and disclosure also lowers the transaction costs in identifying firms that are underperforming due to poor management to target for hostile acquisition.¹⁵⁵ The acquirers can then retain more competent management, improving the performance of the company.

However, disclosure will not always succeed in reducing the agency cost of disloyal management. Managers who are willing to breach their fiduciary duties are equally likely to be willing to breach their disclosure obligations.¹⁵⁶ There are also other negative consequences, whereby disclosing conflicts of interests has been said to have perverse effects on the discloser's behaviour, who after disclosing their interests, unconsciously act as though they have a "moral licence" to act in their own interest, as they no longer feel guilty for having a secret agenda.¹⁵⁷ Studies show that mandatory disclosure of management salary also drives up executive pay, as paying below the industry average signals inferior quality, and also gives a greater bargaining device to prospective management, as if they consider themselves "above average", they surely deserve "above average" remuneration.¹⁵⁸ Few prospective CEOs are likely to profess to being merely average. Further, disclosure obligations come at considerable costs to the issuer, not just in gathering and presenting the relevant information, but the harm done to a business from exposing all its information to suppliers, competitors and competing investment opportunities.¹⁵⁹ It is unlikely that the business's own personal gain in having more eyes on its agency costs would ever justify disclosure on its own. Therefore, while this may be a benefit of disclosure, it is unlikely to be the underlying rational.

¹⁵³ At 717.

¹⁵⁴ At 718.

¹⁵⁵ Enriques and Gilotta, above n 13, at 519.

¹⁵⁶ At 518.

¹⁵⁷ Daylian M Cain and George Loewenstein, and Don A Moore "The Dirt on Coming Clean: Perverse Effects of Disclosing Conflicts of Interest" (2005) 34(1) *The Journal of Legal Studies* 1 at 7.

¹⁵⁸ Enriques and Gilotta, above n 13, at 518; Steven M Davidoff and Claire A Hill "Limits of disclosure" 36(2) *Seattle UL Rev* 599 at 623-624.

¹⁵⁹ Enriques and Gilotta, above n 13, at 521-522.

D *Ensuring Accurate Prices to Facilitate an Efficient Market*

The narrative of this purpose is that disclosure should be used to provide all the information to the market, so that the market can use this information to accurately value the securities.¹⁶⁰ An efficient market is one where the prices are accurate, liquidity is high, and price correction happens quickly.¹⁶¹ This theory relies, at least to a degree, on the truth of the efficient capital market hypothesis (EMH). The EMH is a hypothesis claiming that the price of securities reflects all public information.¹⁶² Modern theorists do not argue that the EMH results in “fundamental efficiency” in that prices fully reflect the fundamental value of a security, but rather, prices reflect “informational efficiency” by reflecting all available public information.¹⁶³ The argument is that fundamental efficiency is impossible, and the task for regulators should be to remove the frictions which lead to divergence between informational and fundamental efficiency.¹⁶⁴ The price reflected from all public information should as close as possible represent the fundamental value. The argument goes that the underlying purpose for disclosure is to provide the market with all the information needed to ensure prices are accurate.¹⁶⁵

The main disclosure requirements under the FMC Act, such as the PDS requirement, relate to the initial public offering of securities (the primary market), with continuous disclosure for listed securities primarily administered by listing rules, such as the NZX Listing Rules.¹⁶⁶ Because issuers initially offering securities are often not listed issuers, the value of the securities on offer will not be determined by the trading value (as they have not been traded yet). However, if disclosure provides the information necessary for the market to value the securities, as soon as the securities are sold they will be subject to market forces correcting any price discrepancies. Reputational intermediaries have a reputational (and in the case of investment banks, often a financial) stake in ensuring the offer price is not overvalued relative to what the market price becomes. In this sense, the IPO price will always be based on how the market is likely to value the securities. The PDS will also continue to be relevant to the trading

¹⁶⁰ Mahoney, above n 104, at 1047-1048.

¹⁶¹ Goshan and Parchomovsky, above n 23, at 714, 720; Fama, above n 105, at 383.

¹⁶² Ronald J Gilson and Reinier H Kraakman "Market Efficiency after the Fall: Where do we stand after the Financial Crisis" in Claire A Hill and Brett H McDonnell (eds) *Research Handbook on the Economics of Corporate Law* (Edward Elgar Publishing, Northampton, 2012) 456 at 458; See Fama, above n 105; also known as the ECMH.

¹⁶³ At 457-458.

¹⁶⁴ At 459-461.

¹⁶⁵ Goshan and Parchomovsky, above n 23, at 713.

¹⁶⁶ Financial Markets Conduct Act 2013, s 270; NZX Limited *Main Board/Debt Market Listing Rules* (22 May 2017).

price after the IPO, as continuous disclosure obligations are unlikely to make redundant all the material facts disclosed in the PDS. Even for securities that are not listed or traded on a secondary market after the IPO, ideally, they should be valued based on what the information suggests they are worth, and disclosure ought to facilitate this. Therefore, the price accuracy narrative is relevant to the initial, as well as continuous, disclosure obligations. Further, the IPO issue price is often determined by a “bookbuild” whereby institutional investors determine the price by making binding bids prior to the IPO.¹⁶⁷ When a bookbuild does occur, the market actually does influence the IPO price before the securities are issued.

1 The benefits of an efficient market

Increasing price accuracy increases liquidity, lowers volatility, protects retail investors and promotes allocative efficiency, which benefits the economy as a whole.¹⁶⁸ Liquidity is enhanced by accurate prices because investors can have faith that the price of a security reflects the public information.¹⁶⁹ This reduces the transaction costs, as investors who wish to acquire publicly traded securities will not need to spend as much investigating, and can thus spend more investing.¹⁷⁰ With lower transaction costs, it is cheaper for investors to switch investments more frequently, which consequently enhances the liquidity of the market as a whole.¹⁷¹ This point can be further illustrated by considering a market where transacting is very expensive. If transactions were expensive, participants would be less likely to switch their investments, and thus less trading activity would occur.¹⁷² All else the same, reliably accurate prices therefore enhance liquidity.

The value of volatile securities can be spread out over a wider range of values. For example, a volatile security might be worth anywhere between \$5 and \$10 on any particular day.¹⁷³ This increases the risks for investors. In a market where prices do not accurately reflect the true value of a security, securities are likely to be more volatile.¹⁷⁴ Accuracy can be enhanced by the market having all the information. Because investors are generally risk averse, a volatile

¹⁶⁷ Chapman Tripp, above n 18, at 9.

¹⁶⁸ Enriques and Gilotta, above n 13, at 519; see discussion below.

¹⁶⁹ Kahan, above n 22, at 1017.

¹⁷⁰ Easterbrook and Fischel, above n 36, at 693.

¹⁷¹ Kahan, above n 22, at 1020.

¹⁷² At 1020.

¹⁷³ At 1025.

¹⁷⁴ Enriques and Gilotta, above n 13, at 519.

market discourages investors from investing, and demands higher returns, thus increasing the cost of obtaining capital.¹⁷⁵

Accurate prices protect unsophisticated investors. If the market incorporates all available information (including external information) into the market price, then unsophisticated investors are able to “free ride” off the sophisticated investor’s efforts (of incorporating the information into the market price) to pay a fair price.¹⁷⁶ Although at the time of the IPO (except when there is a bookbuild) the price is not the result of the market incorporating all the information into the price, the IPO price will inevitably reflect the fact that trading will result in prices that reflect the information. Any significant discrepancy will cause substantial harm to the reputation of both the reputational intermediaries and the issuer.¹⁷⁷

Accurate prices enhance allocative efficiency, by valuing good issuers higher and bad issuers lower.¹⁷⁸ With all cards on the table, the issuers with greater earning prospects are able to flourish. On the other hand, information asymmetries allow firms with poor earnings prospects to obtain more capital than they should. Accurate prices incentivise good issuers to obtain capital via a public securities offering, as they will be rewarded by an investing public that values their effective use of capital, while discouraging bad issuers who cannot make efficient use of the capital. The capital in the economy will hence be allocated efficiently.

Therefore, there are substantial benefits to the economy and to investors if the market has price efficiency. However, that does not mean disclosure necessarily results in an efficient market.¹⁷⁹ Further, the EMH has come under criticism since the Global Financial Crisis (GFC).¹⁸⁰ An argument may also be made that the EMH, being a theory largely developed and applied in the United States, is not applicable to New Zealand. Therefore, this paper will discuss the way information can be used by the market to find whether disclosure can actually lead to greater market efficiency.

¹⁷⁵ Kahan, above n 22, at 1025.

¹⁷⁶ Easterbrook and Fischel, above n 36, at 694; Enriques and Gilotta, above n 13, at 515-516.

¹⁷⁷ See chapter I-D above on why reputational intermediaries are unlikely to sacrifice their reputation for one-off gains.

¹⁷⁸ Coffee, above n 13, at 734-735; Goshan and Parchomovsky, above n 23, at 713.

¹⁷⁹ Mahoney, above n 104, at 1048.

¹⁸⁰ Gilson and Kraakman, above n 162, at 465.

Analysts play a crucial role in causing prices to reflect available information.¹⁸¹ There are three common types of analysts: sell-side analysts, buy-side analysts, and independent analysts.¹⁸² Sell-side analysts are usually employed by investment banks to follow and evaluate certain securities and produce research reports.¹⁸³ Buy-side analysts work for large institutional investors to manage their portfolios, seeking to profit from detecting discrepancies between trading price and actual price by analysing all the relevant information, including the research reports produced by sell-side analysts.¹⁸⁴ Independent analysts produce and sell analytical products, usually through a subscription.¹⁸⁵ Each can be described as “information traders”, as they trade on the basis of information.

When information traders take advantage of price discrepancies, they cause market prices to reflect the available information. When information traders observe an undervaluation, they buy, causing the price to rise, and when they observe an overvaluation, they sell, causing the price to drop.¹⁸⁶ There are three stages to turning information into price valuations. The participants must, (a) gather the information, (b) verify its accuracy, and (c) analyse the information to price it.¹⁸⁷

Without mandatory disclosure, the first two steps would be very difficult. Internal information would only be disclosed when the issuers have sufficient private incentives. Because disclosing causes harm to issuers, particularly by weakening its position with suppliers and competitors, and putting management under greater scrutiny, the general consensus is that socially optimal levels of disclosure are only possible with mandatory disclosure.¹⁸⁸ Another reason voluntary disclosure will not achieve socially desirable results is that information has the qualities of a public good in that any number of participants can use it without it deteriorating. This leads to parties who derive value from the information not paying for it, and thus not sending a market

¹⁸¹ Jill E Fisch "The role and regulation of the research analyst" in Claire A Hill and Brett H McDonnell (eds) *Research Handbook on the Economics of Corporate Law* (Edward Elgar Publishing, Northampton, 2012) 315 at 317-318; Coffee, above n 13, at 728, 731-732; Goshan and Parchomovsky, above n 23, at 726.

¹⁸² Goshan and Parchomovsky, above n 23, at 723; Fisch, above n 181, at 317.

¹⁸³ Goshan and Parchomovsky, above n 23, at 723; Fisch, above n 181, at 317-318.

¹⁸⁴ Goshan and Parchomovsky, above n 23, at 723; Fisch, above n 181, at 317.

¹⁸⁵ Goshan and Parchomovsky, above n 23, at 723; Fisch, above n 181, at 317.

¹⁸⁶ Goshan and Parchomovsky, above n 23, at 726.

¹⁸⁷ At 721.

¹⁸⁸ Coffee, above n 13, at 728; David J Schulte "The Debateable Case for Securities Disclosure Regulation" (1988) 13(2) JCorpL 535 at 537; Easterbrook and Fischel, above n 36, at 681; Enriques and Gilotta, above n 13, at 522; Goshan and Parchomovsky, above n 23, at 718.

signal to the producer to produce optimal amounts.¹⁸⁹ Issuers have even less incentive to disclose after the IPO, because there is no information asymmetry between buyers and sellers of the shares (so buyers will not value by assuming the worst).¹⁹⁰ If disclosure was not mandatory, to complete the first two steps (gathering and verifying) analysts would have to continuously request or even buy it from the issuers. Issuers may in some circumstances comply, as they derive a benefit from having their securities covered by analysts. The securities are benefitted by reducing their volatility, and by having an implicit endorsement by a reputational intermediary.¹⁹¹ This phenomenon would be similar to what was occurring in the United States from the 1970s, known as “selective disclosure”. However, the practice was soon prohibited by the SEC because it led to issuers only disclosing information to analysts who produced favourable reports, and so the market was getting misleading information.¹⁹² Under the FMC Act, a party with material information not generally available to the market is prohibited from trading, disclosing, or encouraging trading, so selective disclosure is seemingly prohibited by insider trading rules in New Zealand.¹⁹³ Therefore, mandatory disclosure plays a vital role in ensuring that analysts are able to gather and verify the information necessary to accurately value the securities. Mandatory disclosure verifies the information with significant penalties imposed on participants involved in misleading disclosure, and is further verified by the role of reputational intermediaries.¹⁹⁴

The third step requires analysing the information to value the security.¹⁹⁵ Such an analysis must take into account a broad range of factors, including both the internal and external firm information.¹⁹⁶ This part of the process can only sensibly be conducted by information traders, as other participants lack the expertise and resources to gather and process the information.¹⁹⁷ Therefore, the theory goes, that the purpose of disclosure is to put all the information into the public domain, so information traders can analyse it and price it, leading to prices which reflect the public information.¹⁹⁸

¹⁸⁹ Schulte, above n 188, at 537; Easterbrook and Fischel, above n 36, at 681.

¹⁹⁰ Goshan and Parchomovsky, above n 23, at 718.

¹⁹¹ Fisch, above n 181, at 317.

¹⁹² At 319-320; Code of Federal Regulations, title 17 § 243.100.

¹⁹³ Financial Markets Conduct Act, ss 234, 240-244.

¹⁹⁴ See for example Financial Markets Conduct Act, ss 490, 512; see chapter I-D above.

¹⁹⁵ Goshan and Parchomovsky, above n 23, at 721.

¹⁹⁶ At 721; Firtel, above n 30, at 867; Fisch, above n 181, at 317.

¹⁹⁷ Firtel, above n 30, at 864-865; Goshan and Parchomovsky, above n 23, at 715; Easterbrook and Fischel, above n 36, at 694.

¹⁹⁸ Goshan and Parchomovsky, above n 23, at 729-730.

By information being more easily available and verifiable, information traders are more willing to find and trade against discrepancies. If information was difficult and expensive to obtain and verify, participants would be less likely to trade against smaller discrepancies, increasing the disparity between actual value and trading value.¹⁹⁹ To illustrate this point, one can imagine that when only a small profit may be earned if substantial resources are put towards obtaining information, and there is a risk of loss because it cannot be verified, information traders will be less likely to do the trade, and thus liquidity and price accuracy suffers. On the other hand, in a perfect market where all the necessary information is freely available and verified, it would be worth the information trader's time to trade against even small discrepancies.²⁰⁰ This increases liquidity and price accuracy. As trading against price discrepancies becomes more profitable (from requiring less resources), the number of information traders is likely to increase, as will competition.²⁰¹ With more competition, prices correct even quicker, and even more external information will become available as participants work harder to seek competitive advantages – further benefitting the efficiency of the market.²⁰² Therefore, the benefits to market efficiency from disclosure can have significant compounding effects.

However, the main criticism of EMH is that, notwithstanding the persuasive theory, it is difficult to conclusively prove that it works in practice.²⁰³ Studies suggest that even market professionals often follow the herd instead of making rational investment decisions, as it is better for one's reputation to be collectively wrong than to risk being individually wrong.²⁰⁴ Nonetheless, the market does not have to be perfectly efficient for the above explanation of disclosure to provide good policy for financial market regulation. So long as the prices are incorporating the available information in a substantial way, that seemingly provides a greater justification for disclosure than the alternate explanations discussed earlier in this chapter. Proponents of EMH base the theory on a perfect market, but are aware it only applies to a practical extent in real markets, nonetheless the theory still holds sufficiently true.²⁰⁵ EMH is

¹⁹⁹ At 737.

²⁰⁰ At 737.

²⁰¹ At 737.

²⁰² At 739.

²⁰³ Mahoney, above n 104, at 1048.

²⁰⁴ Task Force to Modernize Securities Legislation in Canada *Canada Steps Up: Final Report* (October 2006) at 137-138.

²⁰⁵ Fama, above n 105, at 387-388; Gilson and Kraakman, above n 162, at 457-459.

a relative, rather than absolute, hypothesis.²⁰⁶ In essence, the evidence in favour of EMH is extensive, while the contradictory evidence is sparse.²⁰⁷

3 *The acceptance of EMH in the legal culture*

EMH has had considerable acceptance in the legal culture.²⁰⁸ In the United States, in order for a civil claim for defective disclosure to succeed, claimants have to show that they had relied on the disclosure and it caused them loss.²⁰⁹ This requirement threatened to make class actions impossible, as each claimant would have to individually show how they relied on the disclosure.²¹⁰ In *Basic v Levinson* the Supreme Court of the United States adopted a rebuttable presumption of reliance based on the “fraud on the market” theory.²¹¹ The theory is that because share prices are the conclusion of all available public information, any misleading public information defrauds the entire market, and thus anyone who lost out because a reduction of share price relied on the disclosure.²¹² In a recent high profile case the United States Supreme Court was asked to overrule this precedent, but the court reaffirmed their decision, demonstrating the continuing influence of EMH in the legal culture.²¹³ However, issuers were still able to challenge reliance by showing that the market was not in fact efficient in the circumstances.²¹⁴

In New Zealand, the FMC Act has, arguably, also adopted the premise of the EMH. Section 496 of the FMC Act took a similar approach to the United States by adding a rebuttable presumption that misleading statements caused loss if the securities declined in value after the contravention. The Ministry of Business Innovation and Employment (MBIE) believed this not to go as far as fraud on the market, as it does not establish the quantum of loss, which is left to the discretion of the court.²¹⁵ It remains to be seen how the courts will quantify the loss in these circumstances. MBIE’s justification for the presumption was that disclosure information is processed and shared in so many different ways that it would be too difficult to require the

²⁰⁶ At 463.

²⁰⁷ Fama, above n 105, at 416.

²⁰⁸ Ronald J Gilson and Reinier H Kraakman "The Mechanisms of Market Efficiency" (1984) 70 Virginia Law Review 549 at 549-550; *Halliburton v Erica* 134 S Ct 2398 (2014) at 2408, 2410.

²⁰⁹ *Basic v Levinson*, above n 59, at 989.

²¹⁰ *Halliburton v Erica*, above n 208, at 2407-2408.

²¹¹ *Basic v Levinson*, above n 59, at 990.

²¹² At 990.

²¹³ *Halliburton v Erica*, above n 208.

²¹⁴ At 2408.

²¹⁵ Ministry of Business, Innovation, and Employment *Financial Markets Conduct Bill – Officials’ Report Part A: Main Issues* (24 July 2012) at [56], [62]; Financial Markets Conduct Act, s 495.

claimant to prove causation.²¹⁶ This comes very close to accepting the premise that prices reflect the available information, and that misleading disclosure is committing fraud on the entire market. At a minimum, it accepts the “filtration theory”, that retail investors rarely themselves read disclosure, and receive the real benefit when it is filtered through by professional intermediaries.²¹⁷ Although it could be argued that s 496 is simply pragmatic in that it makes reliance easier to show, there still must be some underlying assumption to justify it. For example, the Misuse of Drugs Act 1975 infamously presumes someone is supplying drugs if they possess above a certain quantity – because the reality is they are probably supplying it, but this is difficult to prove.²¹⁸ The presumption reflects the likely reality, it is not just because it makes it easier to prove supply, otherwise the presumption would arise even when a person is caught possessing only a very small amount, or no amount at all. It is unlikely Parliament intended for people to be convicted of supply if they did not supply. Presumably, Parliament does not intend for people to be liable for things they are not responsible for. Thus, arguably the underlying assumption behind s 496, that a price drop is caused by the contravention, is that prices are in fact driven by information.²¹⁹ This puts the FMC Act in an awkward position whereby EMH, or at least the theory that experts analyse the information before it is useful to retail investors, is accepted in relation to imposing a substantial degree of liability on issuers for defective disclosure, but the actual disclosure regime is aimed towards informing retail investors, not towards creating a price efficient market. If disclosure is not used to facilitate EMH, issuers should not be liable on the basis that prices are influenced by EMH.

The FMC Act seems to adopt the theory of efficient markets in other ways as well. The disclosure requirements when issuing new securities for issuers that are already listed on a licenced market are lower.²²⁰ This is similar to overseas jurisdictions, including the United States, where disclosure obligations for listed issuers are lower because the price already reflects all the publicly known information that has come out under their initial and continuous disclosure obligations.²²¹ This lower standard cannot be explained by the theory of informing investors about the offer, because it is unlikely prudent non-expert investors could be expected

²¹⁶ At [59]-[61].

²¹⁷ Firtel, above n 30, at 867.

²¹⁸ Misuse of Drugs Act 1975, s 4(1B).

²¹⁹ For a more comprehensive discussion of section 496 see Elizabeth J Painter “Section 496: A New Era in Civil Liability for Misstatements” (LLB (Hons) Dissertation, University of Otago, 2014).

²²⁰ Financial Market Regulations, reg 49G.

²²¹ Mahoney, above n 104, at 1108-1109.

to look outside the PDS to past disclosures made as part of the issuer's continuous disclosure, and the information they would need made aware of is likely to be the same whether the issuer was previously listed or not.

4 *The applicability of the EMH after the Global Financial Crisis to New Zealand*

The EMH has come under scrutiny after the GFC.²²² If markets are efficient and the price of securities reflects all the public information, how was billions of dollars tied up in overpriced mortgage backed securities (MBS)? EMH proponents have defended their position on the basis that the EMH, in the right conditions, leads to prices reflecting all available information, but not necessarily to prices reflecting their fundamental value.²²³ The problem with the GFC, they argue, is that the frictions between informational efficiency and fundamental efficiency were so great, that the informationally efficient price was not reflective of the actual values.²²⁴ Further, it has been suggested that it is difficult to imagine a market less informed than the market in which claims on senior tranches of collateralised debt obligation asset pools were sold, but rarely traded.²²⁵ There were also sequential information asymmetries. The original mortgagees knew the risks better than the purchasers, who understood them better than credit rating agencies, who understood them better than the ultimate investors, who seem to have known little other than the reputation of the rating agencies.²²⁶ A further problem was that market mechanisms were not enabling the price to reflect all the information.²²⁷ So even if the traders knew that the MBS were trading above their fundamental value, they lacked a low-cost market vehicle to short the MBS, so their value was not able to reflect the available information.²²⁸

Critics could also point to the collapse of finance companies in New Zealand. Arguably, had the financial advisers conducted simple ratio calculations on the finance companies this would have signified unacceptably high levels of risk.²²⁹ If the EMH rests on experts being trusted to accurately value securities, but New Zealand does not have experts who are capable of doing

²²² Gilson and Kraakman, above n 162, at 465.

²²³ At 457-458.

²²⁴ At 460-461.

²²⁵ At 468.

²²⁶ At 468.

²²⁷ At 460.

²²⁸ At 460.

²²⁹ Russell McVeagh "Submission to the Ministry of Economic Development on the Review of Securities Laws" (2 September 2010) at 27.

so, then the EMH may not be appropriate for New Zealand.²³⁰ However, the collapse of finance companies is distinguishable as the securities were not traded on public markets, so the EMH was not applicable. Further, even if some advisers did get it wrong, on the whole, experts could be expected to get it right more often than unsophisticated investors, and a solution which punishes experts by, ironically, depriving them of information they need in order to provide good financial advice, is likely to be counterproductive. Therefore, the GFC and New Zealand's collapse of finance companies is unlikely to defeat EMH, though it may require theorists to be more conservative in assuming that markets operate rationally.

The EMH and much of the research around entrusting information traders to steer the market towards informational efficiency originated in the United States. The United States is a significantly larger market and operates under a different regulatory regime, so it could be argued that it is an inappropriate model to base New Zealand's financial market on. It is inherently difficult to measure market efficiency. Various studies have used tests and calculations to determine the efficiency of the New Zealand market, and seem to conclude it is efficient only to an extent.²³¹ However, regardless of the historical efficiency of the New Zealand capital market, financial market regulation ought to aspire towards creating an efficient market. New Zealand is a developed economy with well-established accounting firms, investment banks, and law firms, with reputational capital.²³² Therefore, under the right regulatory environment there is nothing about the New Zealand market that suggests the price efficiency theories could not apply.

Therefore, the efficiency rationale provides a persuasive narrative for mandatory disclosure. Mandatory disclosure benefits efficiency by improving the ability for the market to incorporate information into price. This incentivises good issuers into the market, and protects all investors by ensuring they pay a fair, market price. Through the presumption of reliance, the FMC Act arguably already presumes an efficient market. Therefore, the efficiency rationale is likely to be the dominant underlying justification behind disclosure. The next chapter will discuss the market participants disclosure should be aimed at to achieve this aim.

²³⁰ Currently a review of the financial adviser regime is being undertaken, see Ministry of Business, Innovation and Employment *Final Report: Review of the operation of the Financial Advisers Act 2008 and the Financial Service Providers (Registration and Dispute Resolution) Act 2008* (July 2016).

²³¹ Denis Kan "Examination of the efficient market hypothesis— the case of post-crisis Asia Pacific Countries" (2007) 18 *Journal of Asian Economies* 294; Nicolaas Groenewold "Share market efficiency: tests using daily data for Australia and New Zealand" (1997) 7 *Applied Financial Economics* 645.

²³² Russell McVeagh, above n 229, at 28.

IV Chapter IV – To Whom Should Disclosure be Addressed?

If the dominant goal and underlying purpose of disclosure is to create market efficiency, a question arises as to whom disclosure should be addressed to best achieve this goal. As discussed in chapter II, the FMC Act leans towards unsophisticated investors, but is tiered at least to an extent.

A Retail Investors

As discussed in chapter III, a significant number of retail investors are likely to have difficulty comprehending disclosure information in a meaningful way.²³³ If retail investors are incapable of accurately valuing equity securities, then targeting disclosure at them will not result in accurate pricing.²³⁴ Therefore, it would not be sensible to entrust retail investors with the task of pricing securities.

Another approach may be to say that disclosure should be targeted at the lowest denominator. Surely if retail investors can understand the information, everyone more sophisticated can too. However, this argument ignores the fact that retail and institutional investors have different information needs. As discussed in chapter I, research shows that institutional investors rely on financial reports, whereas retail investors rely on written narratives.²³⁵ This approach also ignores the compliance and liability costs associated with retail investors.²³⁶ Choosing retail investors as the primary target is thus to the detriment of other audiences.²³⁷ Therefore, retail investors are unlikely to be the most beneficial target of disclosure.

B Information Traders

Information traders are better equipped to comprehend and analyse financial information compared to retail investors, and are thus more likely to lead the market to accurate prices.²³⁸ Even if information traders are not perfectly rational – and research does suggest they do suffer from information overload as well as biases and a herd mentality – it is likely they will get it

²³³ Firtel, above n 30, at 864.

²³⁴ At 865; Goshan and Parchomovsky, above n 23, at 715.

²³⁵ External Reporting Board *Information Needs of Users of New Zealand Capital Markets Entity Reports* (February 2016); H Kent Baker and John A Haslem "Information needs of individual investors" (1973) 136(5) *Journal of Accountancy* 64 at 68; Susan A Bartlett and Roy A Chandler "The corporate report and the private shareholder: Lee and Tweedie Twenty Years On" (1997) 29(3) *The British Accounting Review* 241 at 254; *Chartered Financial Analyst CFA UK annual survey on Financial Reporting and Analysis* (2015) at 3.

²³⁶ See chapter IV-D below.

²³⁷ Firtel, above n 30, at 865.

²³⁸ At 864, 867.

right more often than non-experts.²³⁹ Aside from superior comprehension and analysis, a disclosure regime targeted at information traders has additional benefits since information traders benefit from economies of scale, and are the participants best positioned to steer the market away from information asymmetries.

As discussed in chapter III, to accurately value equity securities requires both internal firm information and external information relating more broadly to the market and economy.²⁴⁰ Although disclosure presents all the internal information, investors that do not trade on the basis of information are unlikely to have a good level of knowledge of all the necessary external information to come to a rational investment decision.²⁴¹ Because information traders are usually invested in and covering many different securities, they benefit from economies of scale.²⁴² The external information that is relevant to one security will often be relevant to the acquisition of another security.²⁴³ This makes gathering the external information more efficient. Thus, even ignoring the likelihood that other investors may not be comprehending disclosure, because of economies of scale, there are other benefits of targeting disclosure at information traders.

Another benefit of entrusting information traders to use disclosure is that they provide the greatest protection from information asymmetries. Information asymmetries in the financial market can threaten to turn the market into a “lemons market”. George Akerlof argued that when buyers value products based on a characteristic shared by the entire market, there will be an incentive for producers in that market to produce inferior products.²⁴⁴ Akerlof’s famous example is based on the used vehicle market. A “lemon” is a word used to describe a bad vehicle. Due to an information asymmetry, purchasers will not know whether a vehicle is a lemon until they have purchased it.²⁴⁵ Because purchasers know that any vehicle they buy may be a lemon, the value they attach to all used vehicles is lower.²⁴⁶ Sellers of lemons will take advantage of the information asymmetry to sell a lemon at the same value as a used car.²⁴⁷ As the value for used cars as a whole decreases, it becomes less desirable for sellers of good

²³⁹ Paredes, above n 130, at 454; Rachlinski, above n 134, at 1185; Task Force to Modernize Securities Legislation in Canada, above n 204, at 137-138.

²⁴⁰ Goshan and Parchomovsky, above n 23, at 721; Firtel, above n 30, at 867.

²⁴¹ Firtel, above n 30, at 888.

²⁴² Goshan and Parchomovsky, above n 23, at 723.

²⁴³ At 723.

²⁴⁴ Akerlof, above n 29, at 488.

²⁴⁵ At 489.

²⁴⁶ At 490.

²⁴⁷ At 489.

vehicles to depart with their goods in that market, because they cannot get fair value, so they leave the market.²⁴⁸ As the number of good vehicles sold decreases, the proportion of lemons in the market increases, which further devalues the entire market as buyers have to take into account the higher chance of getting a lemon. The cycle continues until there are no good vehicles remaining.²⁴⁹

An information asymmetric equities market could follow the same path.²⁵⁰ If market participants cannot obtain (or comprehend) the information necessary to distinguish good equities from bad ones, the value they attribute to all equities will be similar and based on how they value investing in equities as a whole. This incentivises issuers to issue “lemon” equities – because they get to take advantage of the average value to unknowledgeable investors. As this occurs and investors lose money, how they value securities as a whole will decline. Good issuers will no longer be able to obtain sufficient capital in the market, and will look elsewhere, again, increasing the proportion of lemons. The way to avoid a lemons market is to avoid an information asymmetry and ensure investors can accurately value each security, so they know whether something is a lemon before they buy it. As an illustration using the extremes, one can imagine how difficult it would be to disguise a lemon security if all market participants knew and understood everything about each issuer, as compared to understanding only a couple pages of information.

If disclosure is targeted at retail investors who are incapable of distinguishing good securities from lemon securities, there is a much greater chance the market will descend into a lemons market. Investors will get frustrated when they lose money and avoid the market. The way to prevent a market turning into a lemons market is to encourage market participants that are capable of distinguishing good products from lemons.²⁵¹ In the capital markets, information traders play this role. Information traders are less likely to be deceived by lemon securities. By valuing good securities on the basis of their future earning potential, and trading to reflect that, prices will reflect fair value, which protects retail investors, allowing them to free ride off of the work of information traders.²⁵² As information traders are the participants who do this job, disclosure should be targeted at information traders, providing them the information they need

²⁴⁸ At 490.

²⁴⁹ At 491.

²⁵⁰ Black, above n 15, at 786.

²⁵¹ Akerlof, above n 29, at 496.

²⁵² Easterbrook and Fischel, above n 36, at 694; Enriques and Gilotta, above n 13, at 515-516.

to make assessments. Thus, under this theory, retail investors will actually be better protected by aiming disclosure at information traders.

Therefore, for the reasons stated above, and to better achieve the benefits of having an efficient market (as discussed in chapter III), a compelling case can be made that disclosure should be targeted at the experts.

C A Tiered or One-Size-Fits-All Regime

A criticism and counter argument of the approach that disclosure should only be aimed at information traders may be that it could be aimed at all investors. This could achieve the best of both worlds, with greater efficiency from information traders getting all the required information, and retail investors being better informed. However, as discussed in the preceding chapters, it is unlikely that many retail investors are actually deriving any real benefits from disclosure, so the benefits of dedicating a part of disclosure towards them may be outweighed by its negative consequences. Targeting disclosure at retail investors may cause more harm, drive up compliance costs, and lead to over disclosure.

1 Benefits of aiming at all market participants

There may be some benefits in retaining a tiered approach. For one, it allows the narrative that retail investors must consent to the risks to continue. Although this paper has contended that most retail investors do not derive any benefit from disclosure, there is undoubtedly a diverse range of retail investors, including sophisticated ones that do understand disclosure. As discussed in chapter III above, only 2% of survey participants could answer all 7 questions correctly, but by excluding retail investors from disclosure, this 2% will miss out on something they could understand.²⁵³ However, these sophisticated retail investors are also likely to be able to comprehend a more sophisticated disclosure targeted at information traders, so this harm should not be overstated. Another benefit may be that it provides a self-help check on financial advisers, as retail investors can read the disclosure document to understand the risks when they do not completely trust their adviser.²⁵⁴ Nonetheless, given the requirement for financial advisers to exercise care, diligence, skill, and not to mislead, as well as the availability of the financial adviser's disputes resolution regime, this benefit is only of limited value.²⁵⁵ Another argued benefit may be that it encourages participation in capital markets by retail investors.

²⁵³ IFF Research and YouGov, above n 118, at 45.

²⁵⁴ Burn, above n 4, at 156-157.

²⁵⁵ Financial Advisers Act 2007, ss 33, 34; See Financial Service Providers (Registration and Dispute Resolution) Act 2008.

Advisers are expensive, and if retail investors must pay for expert advice, they may be less inclined to invest. The counter to this is, if they invest based only on their own reading of a PDS, they are at a significantly disadvantageous position as compared to information traders, and thus are likely to lose money and confidence in the capital markets. The benefits of including retail investors need to be weighed against the detriments.

2 *Harms caused to retail investors from a tiered regime*

Targeting disclosure at retail investors may cause them harm as it threatens to mislead them into a false sense of security by implying that anyone can read a PDS (or even just the KIS) with no understanding of capital markets (or even what an ordinary share is). The reality is that they are not on a level playing field, and in most cases they lack both a good understanding of all the requisite external information and the ability to comprehend and value an investment in a rational way.²⁵⁶ The way for retail investors to make rational investment decisions in light of the information is to consult with an expert.²⁵⁷ This expert derives no benefit in being able to assist their clients from disclosure being aimed at the retail investor.²⁵⁸ However, if retail investors are fooled by the seemingly simple PDS to believe they can make the investment decision themselves, they are unlikely to consult with an expert, and thus they are trading under a disadvantageous information asymmetry. Further, the reason they often do pay a fair value is not because their ability to comprehend the risks involved, but actually to do with the market price reflecting careful analysis by information traders – who also derive no benefit from disclosure being aimed at retail investors.

An efficiency consideration may also be levied that if retail investors make irrational decisions, this will not assist allocative efficiency, as undeserving issuers will succeed in raising capital at values they should not, while deserving issuers will not succeed to the extent they deserve. Such a consequence will incentivise lower quality issuers to join the market and higher quality ones to issue elsewhere. Another negative consequence is that, without understanding all the information, retail investors are likely to make poor investment decisions and lose money, which will only dissuade potential capital from the financial markets and lead to undesirable social consequences. Therefore, targeting disclosure at retail investors may actually cause more harm than good.

²⁵⁶ Firtel, above n 30, at 864.

²⁵⁷ At 867.

²⁵⁸ At 865.

3 *Increased compliance and liability costs*

Greater disclosure obligations lead to greater compliance and liability costs.²⁵⁹ In the globalised economy, issuers have a choice of where to issue their securities.²⁶⁰ An attractive and efficient disclosure regime will limit compliance costs to that which are reasonably required to promote the dominant goal of disclosure – price efficiency. As equity securities involve buying an ownership stake in the issuer, the compliance costs are borne by the investors – so any burdensome disclosure requirements that are not providing a positive benefit are expenses unnecessarily thrust on investors.²⁶¹ This results in more of the funds raised being expended on transaction costs. Therefore, to the greatest extent possible without undermining the purpose of disclosure, compliance and liability should be minimised.

By requiring disclosure to be aimed at retail investors, careful consideration must be made to ensure retail investors will not be misled. It would be much easier, for example, to argue in litigation that a “prudent non-expert” was misled by the way information was presented, as compared to arguing a professional analyst was misled. Coupled with the presumption of reliance, issuers face liability for misleading non-experts even if the reality is that professionals are the only ones that actually read the information anyway. Therefore, both compliance costs and liability risk are greatly heightened by targeting disclosure at retail investors at great expense to efficiency, when the narrative presented in this paper is that retail investors do not actually derive substantial benefit from disclosure being directed at them.

Another consequence is that smaller firms of less resources will be unable to issue and raise funds from the public. Because issuer transaction costs are relatively similar no matter the size of the issuer, the compliance burden is felt disproportionately by smaller firms.²⁶² Given that once-small tech start-ups have revolutionised the world in the last decade, it is a missed opportunity if they are unable to obtain capital from the public. An alternative remedy may be proposed that we follow Australia. In Australia, a simpler disclosure regime was established for fund raising of under \$10 million.²⁶³ To an extent, New Zealand has a similar regime by allowing for small fund raising with the innovative crowdfunding disclosure exception in schedule 1 of the FMC Act.²⁶⁴ However, this itself is troublesome as it creates the perfect recipe

²⁵⁹ Enriques and Gilotta, above n 13, at 522, 531.

²⁶⁰ Black, above n 15, at 783-784.

²⁶¹ Easterbrook and Fischel, above n 36, at 696.

²⁶² Enriques and Gilotta, above n 13, at 529.

²⁶³ Corporations Act, s 409(4).

²⁶⁴ With crowdfunding, issuers are able to raise up to \$2 million every 12 months without providing a PDS; See Financial Markets Conduct Act, sch 1, cl 6.

for a lemons market. By keeping disclosure at an ideal efficiency level (where all that is needed for efficiency is disclosed, but nothing more), small firms could be encouraged to fundraise without compromising the quantity and quality of information provided to the market.

Investors and issuers are naturally partners rather than adversaries.²⁶⁵ By taking care of issuers, retail investors are benefited, vice versa.²⁶⁶ With an easier compliance regime that does not compromise the market efficiency goals of disclosure, retail investors will be benefited by more and better issuers choosing to list in New Zealand, allowing greater diversity and competition between issuers. Further, as equity securities are an ownership stake, any burdensome compliance costs are ultimately borne by the investors. Therefore, for the benefit of retail investors and the market as a whole, disclosure would be better if kept limited and only required disclosure to the extent necessary to inform information traders for market efficiency.

4 *The risks of over disclosure*

Another negative consequence of a disclosure regime aimed at every audience is over disclosure. Under the FMC Act, directors and their advisers can be personally liable for loss suffered by investors due to statements being misleading to non-expert investors.²⁶⁷ Although a stringent liability regime may ensure the accuracy of statements, by requiring disclosure to be targeted at non-experts, issuers are incentivised to fill their disclosure with pessimistic narratives shrouded in cautionary terms and boiler plate risk factors, which give little insight into the issuer's actual competitive position.²⁶⁸ In the same way the villagers began to ignore the shepherd-boy when he cried wolf every day, investors naturally begin to gain nothing from an overly pessimistic and cautionary approach.²⁶⁹ As retail investors begin to take nothing from disclosure, they become even less likely to read it, thus further defeating the purpose of aiming disclosure at them, and lessening the effect of any genuine warnings.²⁷⁰ If disclosure was only aimed at professional investors and advisers, the cautionary approach could be avoided as professionals are unlikely to persuade a court they were misled when information was disclosed in an objectively factual way. Therefore, the over cautionary approach that is encouraged by targeting disclosure at retail investors actually has a harmful effect on the quality of the disclosure.

²⁶⁵ Burn, above n 4, at 167-168; Smith and Dixon, above n 44, at 696.

²⁶⁶ At 167-168.

²⁶⁷ Financial Markets Conduct Act, ss 489, 510.

²⁶⁸ Firtel, above n 30, at 870.

²⁶⁹ At 870.

²⁷⁰ At 870.

By translating financial information into simplified terms, the quantity of information is likely to be longer. For example, consider the length of the advice required for one lawyer to fully inform another lawyer of the likelihood and consequences of fiduciary duties arising in a certain fact situation, as opposed to the length required to fully inform an unsophisticated client. The version to the client would need to explain everything from the ground up, from the role of equity, to fiduciary duties, to de-facto fiduciary relationships, to equitable remedies and trusts, and will probably omit details that would be important to a lawyer because they cannot be explained in simple terms. No lawyer is ever likely to need to inform a lay client to such a degree, but in the context of the FMC Act, if the investors are not fully informed, they could argue that they were misled. This results in the issuer having to simplify the language so retail investors can understand it, and then the information traders must try to ascertain all the information that is actually important to them, while skipping over the fluff. While the reality is that most issuers will continue to provide the complex data desired by professionals, a literal reading of the FMC Act would suggest they do not have to, and may even be prohibited from doing so.²⁷¹ Another negative consequence is that the transaction costs for acquiring securities may increase, as the task of analysing all the information is larger – meaning greater resources are expended – and so the cost of deciding whether to invest is larger. A good disclosure regime results in investors spending less on investigating and more on investing.²⁷² Therefore, since retail investors are not really deriving any benefit from disclosure, and including them as a target in a tiered disclosure scheme has many negative consequences, on balance, a disclosure regime will be more efficient if targeted just at information traders.

²⁷¹ See chapter II-C above.

²⁷² Easterbrook and Fischel, above n 36, at 693.

Conclusion

The conclusion of this dissertation is that mandatory disclosure for equity securities is targeted at the wrong audience. The dominant rationale for disclosure in the 21st century is likely to be to ensure the market has sufficient access to information to allow prices to closely reflect their true value. The scheme of the FMC Act, including the presumption of causation, and the lowered disclosure requirements for listed issuers, already assumes the operation of the EMH, so the disclosure regime ought to reflect this. The other rationales for disclosure are either insufficient to justify mandatory disclosure, or not actually achieved by disclosure. This holds true even for primary market disclosure, as prices will quickly adjust after the securities are issued if, based on the information disclosed to the primary market, the market detects a price discrepancy. If this is the dominant purpose, the next issue for regulators is to whom disclosure should be addressed to be consistent with this rationale.

It is common ground amongst most academic commentators that retail investors are ill-equipped to lead the market to efficient prices. A compelling case can be made that sophisticated analysts are the correct agents to incorporate information into prices. However, an argument could also be made that a tiered regime, where the information needs of both sophisticated and unsophisticated investors are satisfied would be better. A tiered regime achieves the best of both worlds, with many of the criticisms of aiming at retail investors being remedied by tiering part of the disclosure towards sophisticated investors. The problem with the tiered regime is that, if we accept the premise that the dominant goal of disclosure is to provide information to the market so that it can be incorporated into prices, and unsophisticated investors are incapable of performing this role, no efficiency gain is made by targeting disclosure at unsophisticated investors. On the other hand, including unsophisticated investors as a target of disclosure substantially increases the compliance, liability and investigation costs, which are ultimately borne by those investors. It may also have the consequence of harming unsophisticated investors by misleading them. If we conclude that most retail investors are incapable of making rational investment decisions based on disclosure alone, encouraging them to make investment decisions based on their reading of disclosure documents inevitably encourages them to make irrational investment decisions. Therefore, perhaps counter-intuitively, targeting disclosure at only sophisticated investors is likely to achieve greater efficiency and benefits for retail investors than a tiered regime.

Therefore, this paper contends that section 49 of the FMC Act (Purpose of PDS) should be amended. The amendment could state under a separate subsection that the PDS for equity securities is to provide certain information that is likely to assist sophisticated investors to determine the value and to decide whether or not to acquire the equity securities. The same might be appropriate for other types of securities as well, but that discussion falls outside the scope of this paper. Section 59 of the FMC Act (Meaning of material information in this Part) could likewise be amended, in the case of equity securities, to reflect that material information is information that a sophisticated investor would expect to, or be likely to, influence sophisticated investors in deciding whether or not to acquire the equity securities on offer. For consistency, section 231 of the FMC Act (Meaning of material information) should be similarly amended. Amendments to the FMC regulations, particularly the mandatory warnings such as the explanation of an ordinary share, and the page and word limits, could also be amended to reflect the change in target audience.

A more radical solution to the problems presented in this paper could be to simply ban retail investors from investing in equity securities, or from investing without advice. The contention of this paper is that this is not necessary. As discussed in chapter I, one of the biggest problems facing New Zealand's securities market is that it lacks sufficient investment – making it more difficult for participants to invest will only compound this problem. In the secondary market, if the market is efficient, retail investors will generally be protected from making irrational investment choices by trading prices reflecting all the public information. The primary market is more complicated, especially if the IPO price is not the result of a bookbuild, making the investment riskier as the price has not been tested by the market. It may be unwise for an investor to subscribe for the offer price if they have no basis for concluding the accuracy of the offer price. However, investors can still rely on the reputational intermediaries, while undoubtedly some investors (such as the more sophisticated retail investors) will have a basis for concluding the offer price is fair, and others will be professionally advised. Banning retail investors from the primary market would substantially limit the ability for firms to raise capital from the public market, and largely defeat the purpose of a public market, as issuers can issue securities to institutional investors privately without having an IPO. It would also give institutional investors a monopoly in the secondary market. Therefore, a more appropriate remedy may be a mandatory warning statement on the PDS. The statement could advise that investing in the primary market has additional risks, that unsophisticated investors should be professionally advised, that the PDS is targeted towards sophisticated investors and that the

primary market for equity securities is appropriate for investors willing to accept greater risk and dedicate the time and resources into determining if the investment is wise. Separately, attempts should also be made towards educating investors that if they wish to invest in a low maintenance manner with less risks, investments in managed funds may be more appropriate.

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