Essay on Securities Regulation and Finance

by

Gordon Walker*

1. INTRODUCTION

Securities regulation is the term lawyers use to describe the legal regulation of securities markets. These markets are an intersection for investors and issuers as well as various disciplines including economics, financial economics, finance theory and practice, and, law. Insights from extra-legal disciplines enrich our understandings of securities market regulation. So, for example, George Akerlof published an analysis of asymmetric information flows in 1970 that provided the economic base case for prospectus disclosure in securities markets.1 In the late 1970s, finance theory in the form of the efficient markets hypothesis (EMH) had a profound effect on the theory and practice of securities regulation in the United States (if not elsewhere).2 In the late twentieth century, research from financial economics furnished by Rafael La Porta and colleagues provided valuable material for securities market policymakers because of its emphasis on the significance of minority investor protection - the so-called “law matters” thesis.3

* Professor Gordon R. Walker, SJD (Duke) is Head of School at La Trobe University School of Law, Melbourne, Australia. This essay was presented as a public lecture at the University of Hong Kong, Faculty of Law on 18 September 2006 when the author was Paul Hastings Visiting Professor of Corporate and Financial Law at Hong Kong University, Faculty of Law, and The Asian Institute of International Financial Law. Thanks to Paul Hastings Janofsky & Walker LLP and the Asian Institute of International Financial Law.


2 “[T]he efficient market hypothesis is the intellectual framework within which current disclosure policies are formulated and their operation assessed.” James Cox, Robert Hillman and Donald Langevoort, Securities Regulation: Cases and Materials, 4th ed. (New York: Aspen, 2004), 98.

3 Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny, “Law and Finance” (1998) 106 (6) Journal of Political Economy 113. For a literature review, see the discussion of the work of La Porta and colleagues in G. Walker, “Corporate Governance in East Asia: Prospects for Reform” in C. K. Low, ed., Corporate Governance: An Asia-Pacific Perspective (Hong Kong: Sweet & Maxwell Asia, 2002), 568-592. The work of La Porta and colleagues continues to have a powerful contemporary resonance. See, for example, recent developments in Brazil where the stock market regulator has ruled to prevent controlling shareholders, who own voting stock, to vote their shares on matters that could benefit themselves
From the mid-1980s, the sub-discipline of behavioural finance – the study of how psychology affects finance - brought a new descriptive realism to the field of securities regulation by a focus on the way in which investors actually make investment decisions. Behavioural finance challenges some of the assumptions of EMH, a key plank of modern finance theory which came to exert a powerful influence on North American academic discussions of securities market regulation after 1970.

In the U.S., for example, the so-called “fraud on the market” theory as articulated in *Basic Inc. v Levinson* 485 U.S. 224 (1988) is based on EMH. By contrast, EMH has not found a large audience amongst regulators or courts in the United Kingdom and the former British enclaves in the Southern hemisphere.

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5 The seminal article is Ronald Gilson and Reiner Kraakman, “The Mechanisms of Market Efficiency” (1984) 70 Virginia LR 549. “Of all the recent developments in financial economics, [EMH] has achieved the widest acceptance by the legal culture … In short, the EMH is now the context in which serious discussion of the regulation of financial markets takes place.” Id, 549-550. Note, however, that EMH is based on utility theory, which is designed to provide a normative model of expected behaviour for economic actors. A key assumption of utility theory is the rational actor - the assumption that economic actors will act in their rational self-interest. This assumption is problematic and is discussed further infra.

6 See the discussion of the case in Cox, Hillman, Langevoort, op. cit., 681ff. The theory is under attack: see *The Economist*, September 9 2006, 74 (discussing the case of Jamie Olis, a tax accountant with Dynegy); Bradford Cornell and James Rutten, “Market Efficiency, Crashes and Securities Litigation” (December 2005; available on www.ssrn.com). One solution to the problems identified by these writers is to abandon the theory and replace it with a statutory prohibition on misleading and deceptive conduct in relation to securities: see the discussion of s. 1041H of the Corporations Act, 2001 (Cth) infra.
As stated, one current debate in the financial theory literature concerns the application of insights derived from behavioural finance which challenge the prevailing orthodoxy of EMH.\(^7\) Taking a cue from this debate, some legal academics have sought to tease out implications for securities regulation.\(^8\) Market efficiency, for example, is a relevant consideration in discussions of investor protection in secondary markets.\(^9\) But what are the implications for investor protection in secondary markets if some investors are irrational and markets are inefficient?

In this essay, I argue that the EMH versus behavioural finance debate is \textit{largely} irrelevant to the core aims of securities regulation – the prevention of fraud and investor protection via disclosure of material information.\(^10\) To be sure, behavioural finance tells us that irrational investors may make bad investment decisions for a variety of reasons. But this insight tells us nothing we do not know already or intuitively.\(^11\) My thesis is that the United Kingdom – and by extension the former British enclaves in the Southern hemisphere such as Hong Kong, Malaysia, Singapore, Australia and New Zealand which all adopted United Kingdom law – had developed a powerful and “classic legal genealogy” or rationale for securities


\(^8\) See supra, n.4.

\(^9\) Shleifer, op.cit, 191. If markets are efficient, then investors in secondary markets can rely on prices to supply “fair” information upon which to make investment decisions. To the extent that individual stock prices may deviate from “fair” prices, then the solution for investors is to buy an index fund. If both propositions hold, a degree of investor protection is attained.


\(^11\) The assumption of rational behaviour has been questioned for some time in the economic literature. See, for example, the discussion on the problem of rational behaviour in John Von Neumann and Oskar Morgenstern, \textit{Theory of Games and Economic Behaviour} 3rd ed. (Princeton: Princeton University Press, 1953), 9. The historical literature is replete with examples of irrational behaviour. See, eg, David Colbert, \textit{Eyewitness to Wall Street} (New York: Broadway Books, 2001). In terms of the operation of present day markets, consider the case of Hong Kong. “Economists may claim that [EMH] drives financial markets. This assumes that traders in the financial markets make rational use of all available financial information … On the practical side, rational decisions are not always made, as some financial market participants have a narcotic attraction to gambling. The securities markets may fulfil the psychological needs of many people who lack long term investment interests … financial markets are casinos for those players who wish to treat them as such … As in certain other jurisdictions, the Hong Kong financial markets have many elements of gaming, in fact if not in law.” Berry Fong-Hsu, Douglas Arner, Maurice Kwok-Sang Tse and Syren Johnstone, \textit{Financial Markets in Hong Kong} (Oxford: Oxford University Press, 2006), 26-27. Emphasis added.
regulation long before EMH – or indeed, any other finance theory - became mainstream. It is this genealogy that should continue to inform governmental regulation of securities markets in those countries. Of course, it is undeniable that finance theory - and especially financial economics - offer rich insights for financial market policymakers (see, for example, the work of La Porta and colleagues on the so-called “law matters” thesis).\(^{12}\) Again, EMH provides at least one rationale for continuous disclosure by listed entities (investor confidence in the market is another).\(^{13}\) But we should be wary of pushing the insights of EMH (or any other finance theory) too far. At some point, for example, the EMH emphasis on disclosure of information may become unproductive.\(^{14}\) By contrast, modern formulations of the classic legal genealogy of securities regulation continue to provide the best conceptual foundation for securities regulation being grounded in law’s experience with markets and investors rather than the “logic” of modern finance theory.\(^{15}\)

\(^{12}\) Supra n. 3.

\(^{13}\) See, eg, Australian Stock Exchange Listing Rule 3.1 (obligation to provide immediate notice of material information). “The requirement of continuous disclosure is based on the market information principle, an assumption that the efficiency of a capital market depends on the amount of information available to, and its distribution, among investors.” Annotated Listing Rules (Sydney: CCH Australia Limited) at 13, 053. Consider the CuDeco and Jubilee Mines disclosure cases in Australia. These cases show that exaggerated or non-disclosure of material information leads to inefficient market outcomes: Michael West and Kevin Andrusiak, “The X Files” The Weekend Australian, July 22-23 2006, 31 (discussing exaggerated disclosure in the CuDeco case); Marsha Jacobs, “Miner must pay $1.8 million for keeping find secret”, The Australian Financial Review, 7 September 2006, 3 (discussing non-disclosure by Jubilee Mines). For analysis of the Australian position, see Greg Golding and Natalie Kalfus, “The continuous evolution of Australia’s continuous disclosure laws” (2004) 22 (6) C&SLJ 385. It is clear, however, that the introduction of continuous disclosure rules in Australian legislation – now Chapter 6CA of the Corporations Act, 2001 (Cth.) - was the result of entrepreneurial boom and bust in the late 1980s and that investor confidence and protection provided the fundamental policy basis. See id., 386-7. To the same effect, see Editorial, The Australian Financial Review, 21 August 2006, 62. In a similar vein, the Sarbanes-Oxley Act is intended to improve investor protection but may have the effect of improving market efficiency. See Paola Cioppa, “The Efficient Capital Market Hypothesis Revisited: Implications of the Economic Model for the United States Regulator” (2005) 5 (1) Global Juristic Advances. Available at www.bepress.com/gj

\(^{14}\) See Troy Paredes, “Blinded by the Light: Information Overload and its Consequences for Securities Regulation” (2003) 81 (3) Washington ULR 417. Cognitive psychologists think that human “channel capacity” is limited and can be overwhelmed by information overload: see the discussion in Malcolm Gladwell, The Tipping Point (London: Abacus, 2001), 175ff. This line of research has radical implications for the mandatory disclosure debate because it suggests that there is a finite point beyond which disclosure is ineffective and inefficient.

\(^{15}\) See, eg, sections 2-6 of the Financial Services and Markets Act, 2000 (UK); sections 4-6 of the Securities and Futures Ordinance, 2002 (HK). For commentary on this legislation, see respectively, Michael Blair and George Walker, eds, Financial Services Law (Oxford: Oxford University Press, 2006) and Fong-Hsu, Arner et al, op. cit.
This essay begins by sketching two main theories of securities regulation: no government regulation (the so-called “null hypothesis”) or some form of government regulation. Early examples of these theories are seen in the “light handed regulation” of the Amsterdam Bourse and the governmental response to the South Sea Bubble in England in 1720. After a background account of the development of the English law pre-1844, I describe the classic legal genealogy of securities regulation beginning with the report of the Gladstone Committee in 1844 through to the Financial Services and Markets Act 2000 (UK). While the key concepts (prevention of fraud and investor protection) evolve in sophistication and scope over time, the central tenets remain. In the next part of the essay, I review the EMH and some of the insights flowing from the behavioural finance literature. In the conclusion, I consider some implications for securities regulation.

2. TWO THEORIES OF SECURITIES REGULATION

Although early forms of stock markets existed before the seventeenth century,16 the consensus among financial historians is that the precursors to modern stock markets emerged in Amsterdam and London in the seventeenth century.17 The early stock markets of Amsterdam and London provide imperfect but useful illustrations of two divergent approaches to securities market regulation. Edward Stringham dates the beginnings of the Amsterdam market at around 1602.18 Certainly, we know there was an active stock market in Amsterdam before 1688, the year in which the first treatise on speculation – Confusion de Confusiones - by Joseph de la Vega was published.19 Similarly, we know there was an active stock market in London in the seventeenth century from evidence of stock price quotations in Whiston’s, The Merchants Remembrancer, published in July 1681.20 By 1695, at least 150 corporations had their shares publicly traded in London and the trade in public debt and corporate shares had

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19 Neal, op. cit., 16.
20 Id., 21.
become centralised in Exchange Alley. An industry of stock brokers and speculators had emerged and the instruments we know as “calls” and “puts” were used. Part of this growth was the result of government participation. As a result of its wars in Europe, the British government had developed a substantial national debt. Much of this debt was unconvertible, non-transferable and carried a high rate of interest. To persuade investors to agree to convert this debt into a more convenient form, the British government arranged for the creation of trading companies on the model of the British East India Company (EIC) and offered shares in these new companies to both the public and existing debtors.

Despite government involvement, the securities market had already acquired a reputation as a place of immorality and deceitfulness. This early characterisation of the securities markets is well-documented by Stuart Banner in his study of the beginnings of securities regulation in the period 1690-1860. Not only were participants in the market likely to cheat outsiders who sought to deal with them and manipulate markets to their own ends but also the activity of securities trading was seen as unproductive and a drain on the national economy.

A consistent theme in Anglo-American securities regulation is that government regulation and enforcement is necessary for the development of stock markets. Stringham, however, has demonstrated that the Amsterdam Bourse developed advanced trading instruments which state courts were unaccustomed and unable to handle. He finds, for example, that Amsterdam stockbrokers - in the absence of a legal system to rely on - conducted their business relying on reputation and the

23 L. Neal, op cit., 13, 97-113. Neal suggests that much of the South Sea Bubble can be attributed to the fact that the volume of shares being offered exceeded the capital capacity of the markets at the time.
24 Banner, op. cit.
25 "Much of the dealings that took place were actually prohibited by law, although the law was ineffective and not strictly enforced. This relatively free atmosphere allowed the traders to experiment and devise new trading instruments, even though they were officially proscribed. The development … was not due to government directive but self-interest of traders … In contrast to the position that financial markets depend on government rules and regulations, the historical record lends credence to the theories that contracts can be self-enforcing and that market participants can police themselves." Stringham , op. cit., 2.
discipline of continuous dealings”. Stringham’s findings provide some early evidence for one of the main theories of Anglo-American securities regulation, the so-called “null hypothesis” of securities regulation usually associated with Coase and Stigler. This theory is simple: securities markets should not be regulated by governments. Market and general law mechanisms are sufficient. The theory, however, is no more than a theory: after all, there is no developed securities market in the world today that operates without some form of governmental regulation. In my view, it is unrealistic and unproductive to argue otherwise.

The second main theory is that securities regulation “matters”. It matters – so the argument runs – because a government provided securities regime provides investor protection via a (default) contracting framework that can be enforced privately or by the state. One leading modern formulation of this view is provided by Bernard Black. The theory has empirical support - all developed countries in the world have some form of government regulation. The emblematic stock frauds of the South Sea Bubble in England, which led to the regulatory response of Bubble Act of 1720, provide early concrete evidence for this theory, albeit in an extreme fashion. (The governmental response to the South Sea Bubble was draconian – the Bubble Act prohibited joint stock companies altogether.) To fully appreciate the impetus for the dominant theory, however, we need to examine at the genealogy of English laws designed to protect investors from stock frauds. As stated, I call this the classic legal genealogy of securities regulation in order to distinguish it from explanations derived

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26 Id., 4.
28 Ibid. There are obvious differences between the intimate securities markets of seventeenth century Amsterdam and the vast impersonal markets of the 21st century. Further, the Coasean transaction costs associated with such transactions must have been high (ex ante) in the absence of a (default) system of external rules.
29 This line of argument has a long history. See Frank Easterbrook and Daniel Fischel, “Mandatory Disclosure and the Protection of Investors” (1984) 70 Virginia LR 669, 673-677.
31 The reference is to the so-called “law matters” thesis associated with La Porta and colleagues. The references are collected in Walker, op. cit.
34 Smith describes an earlier example of governmental intervention in England in 1697 when the number of licensed brokers was proscribed. See Smith, op. cit., 23.
from economics or finance theory. It prevailed unchallenged in the years 1844 to 1970, the year in which Eugene Fama produced the fully-developed version of EMH.  

3. THE CLASSIC LEGAL GENEALOGY

Background: 1720 to 1844 – From the Bubble Act to the beginnings of limited liability

Anglo-American securities regulation regimes spring from a common well – English law. In England, securities regulation was the child of company law. Historically, it was – as we say now - embedded in company law. The reason is obvious; capital raising and associated matters were largely activities carried out by companies, their promoters and directors. This explains the existence of company legislation and case law directed at capital raising entities and those who governed them. In the early development of English company law, the corporate form evolved to serve the needs of the economy at that particular time - a classical process of evolution-to-efficiency. Thus, early English corporate law was concerned with municipal, ecclesiastical, educational and charitable corporations rather than commercial or business companies. Then, in the sixteenth and seventeenth century era of discovery and colonisation, the Crown granted charters of incorporation to trading companies in order to develop foreign trade. With the advent of the industrial revolution, companies were formed by special or private Acts to engage in large infrastructural developments, such as the construction of canals, railways and public utilities, which were considered of national importance. At the same time, more mundane commercial activities were undertaken by unincorporated joint stock companies which did not enjoy limited liability. The utility of the unincorporated joint stock

35 For a review of the key dates in the development of modern finance theory, see Peter Bernstein, *Capital Ideas* (New York: The Free Press, 1992). The time line is important for my argument since, as stated, the law had developed a rationale and mechanisms for securities market regulation long before finance theory appeared.


38 Ibid.

39 Ibid.

40 On the distinction between incorporated and unincorporated joint stock companies, see P. Ireland, “Capitalism without the Capitalist: The Joint Stock Company Share and the Emergence of the Modern Doctrine of Separate Legal Personality” (1996) 17 The Journal of Legal History 41.
company as an engine of a capitalist economy had been recognised as early as 1700.\footnote{B. Hunt, \textit{The Development of the Business Corporation in England 1800-1867} (1936), 6.} But formation of joint stock companies by registration and the privilege of limited liability was not a matter of general right until after the middle of the nineteenth century: “Freedom of incorporation was achieved only after a protracted and bitter struggle against deeply rooted prejudice and even fear.”\footnote{Ibid. See also M. Lobban, “Corporate Identity and Limited Liability in France and England 1825-67” (1996) 25 Anglo-American Law Review, 397.} The principal reason for this protracted delay was the South Sea crash of 1720,\footnote{Ibid. See also, A. Du Bois, \textit{The English Business Company after the Bubble Act 1720-1800} (1938) 203 and the sources cited in L. Loss and J. Seligman, \textit{Securities Regulation}, Vol. 1 (3rd ed., 1989), 4-6.} which disrupted the classical process of evolution and corporate development for well over a century.

Extensive stock market speculation took place in the last decade of the seventeenth century. The South Sea Company, created by Royal Charter in 1694, played a major part in this upsurge of activity. The company’s success in manipulating its stock price encouraged a wave of company promotions and speculation.\footnote{See P. Baron, “Bringing Back the Bubble? Regulation of Corporate Abuse by an Action in Public Nuisance” (1992) 11 University of Tasmania LR 149 for a closely researched account of the Bubble Act and the subsequent case law.} In 1719, the South Sea Company launched a privatization scheme to acquire the English national debt by converting that debt into shares of its own stock. The Bubble Act of 1720\footnote{6 Geo. I, c. 18.} authorised this scheme and purported to prevent the public from investing in unchartered companies. Proceedings were commenced against unchartered companies. The enforcement proceedings had the consequence of provoking a bear market in the shares of unchartered companies and ultimately of the South Sea Company itself. Hunt puts it nicely: “The weapon which the aggressors had launched proved a boomerang of crushing force.”\footnote{Hunt, op. cit., 8.} The joint stock system as such was blamed for the ensuing South Sea crash of 1720, and this arrested the development of the joint stock enterprise. Of the Bubble Act itself, one report stated that, “like all laws passed upon \textit{the exigency of an occasion} it had more of temporary malice and revenge than of permanent wisdom or policy.”\footnote{Ibid. Emphasis added. Query the application of this remark to the collapse of Enron and the passing of the Sarbanes-Oxley Act of 2002.}
An explanation of the Bubble Act based on the economics of regulation might be that it represented a misguided attempt to regulate an incipient market failure. However, the better view is that the Bubble Act was simply a response to initial, accidental conditions that deeply affected the subsequent development of corporate law long after the initial conditions had disappeared because of the chilling effect the response had on the evolution of the joint stock system. It represents an evolutionary crisis in the development of corporate law because that which survived the Bubble crisis was maladapted to serve the needs of English industry. Certainly, one salient consequence of the Bubble Act was to retard the classical evolutionary paradigm.

The Bubble Act was repealed in 1825 during a speculative boom. One specific ground for repeal was that the legislation had restrained the formation of companies “established on just and equitable principles and for laudable objects”. Notwithstanding this repeal, the courts looked unfavourably at the unincorporated joint stock association. Despite this judicial (and other) resistance, various forms of joint stock enterprise - whether corporate, quasi-corporate or unincorporated - grew

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48 According to the market failure theory of regulation, government intervention in the market is justified when markets are seen as “failing” (where failure is deviation from the norm occurring in a fully competitive market). Market failure is the inability of an unregulated market to achieve allocative efficiency in all circumstances. In financial industries, market failure includes fraud, manipulation, deception, public loss of funds, and corporate collapse. On market failure, see Douglas McTaggart, Christopher Finlay and Michael Parkin, Economics, 4th ed. (Sydney: Pearson, 2006), Chapter 16 and S. Phillips and J. Zecker, The SEC and the Public Interest (1981), 17ff. The theory supplies a useful justification for establishing a regulatory regime in the public interest although some doubt whether any scheme of regulation can prevent such occurrences. Id., 19.

49 Hunt states: “The Act of 1720 and the ensuing collapse of the great speculation arrested the development of joint-stock enterprise for many decades. In sum and in consequence, incorporation remained particular, not general. As Marshall has observed, we might otherwise have expected the spread of joint-stock enterprise over English business in that century. And, in any event, there seems no doubt that for upwards of a hundred years, industry was deprived of capital which in other circumstances would have been available. The legislation of 1720 was, in fact, to exercise a deterrent psychological effect upon company promotion even after its repeal under the pressure of a rising industrialism a century later.” Hunt, op. cit., 9.

49 “In fact, the history of the business corporation or joint stock company in England during the one hundred and fifty years following the statute of 1720 is the story of an economic necessity forcing its way slowly and painfully to legal recognition against strong commercial prejudice in favour of ‘individual’ enterprise, and in the face of determined attempts of both the legislature and the courts to deny it.” Id., 13.

51 6 Geo. IV, c. 91. See Hunt, op. cit., 41.

52 Hunt, op. cit., 41.

steadily in the period 1830-1844. This growth was intimately connected with the introduction and extension of the railway system and the development of the sharemarket. While it is clear that the sheer volume of investment in such investment vehicles was a factor prompting reform, the immediate impetus for the appointment in 1841 of a parliamentary committee on joint stock companies (later known as the Gladstone Committee) was a desire for individual investor protection against abusive practices of company promotion. This focus on individual, as opposed to institutional, investor protection is not surprising since the overwhelming majority of investment appears to have been undertaken by individuals or their proxies. In this way, the rationale for legislative intervention in the form of individual investor protection was linked to the ownership structure of the market at the time.

The Report of the Gladstone Committee was released in 1844 and was the basis of the Joint Stock Companies Registration and Regulation Act 1844 (UK). This was the first general Companies Act to draw a distinction between a joint stock company and an ordinary partnership. In return for certain registration requirements (name, address and purpose), some of the privileges of incorporation were made available, however,
the company’s members remained subject to unlimited liability. Hunt argues that the legislation was less about giving facilities to companies than about providing a measure of protection for the public. 60 It was not until the Limited Liability Act 1855 (UK) that members of joint stock companies were granted the privilege of limited liability. 61 Under this Act, the liability of shareholders was limited to the amount paid for shares. But earlier safeguards, such as registration of prospectuses and minimum paid-up capital, were discarded. 62 Subsequently, the Companies Act 1862 (UK) made incorporation with limited liability available to all legitimate businesses. 63 The Companies Act 1867 (UK) 64 was passed in the wake of the crash of 1866 and marks the beginning of statutory prescription of the contents of the prospectus. 65 These Acts represent key steps in the classical evolutionary paradigm of corporate development. The struggle for limited liability was one limb of this development. The second limb is represented by the establishment of the disclosure principle by the Gladstone Committee.

Limited liability is often claimed to be a cornerstone of the Industrial Revolution in England. In 1926, The Economist stated: “The economic historian of the future, may assign to the nameless inventor of the principle of limited liability, as applied to trading corporations, a place of honour with Watt and Stephenson, and other pioneers of the Industrial Revolution”. 66 By establishing limited liability, according to another contemporaneous writer, England took “the crowning step in removing the fetters from human industry, by removing from her code the last of those enactments which [could] impede a free development of her industrial resources.” 67 During 1750-1850, the primarily agricultural society of England and Wales was transformed into the commercial and industrial leader of the world. 68 The transformation required massive investment in infrastructure - roads, railways and canals - as well as the growth of the City of London as “a world-wide influence, as a financial institution, in commercial,  

60  Hunt, op. cit., 89.  
61  18 & 19 Vict., ch. 133. The Limited Liability Act of 1855 was repealed but substantially re-enacted in 1856 as 19/20 Vict., ch. 47.  
63  25 & 26 Vict., ch. 89.  
64  30 & 31 Vict., ch. 131.  
65  Hunt, op. cit., 156.  
67  Id., 117.  
68  Manchester, op. cit., 2ff.
The prerequisites of an industrial economy were well-established in England by the mid-nineteenth century. English prosperity was exemplified by the Great Exhibition of 1851 housed in the Crystal Palace in London, an event which symbolised the country’s commercial and industrial wealth.

In the view of the Gladstone Committee, disclosure was the prime means of achieving investor protection. By this time it was clear that speculative booms were not merely chaotic, one-off occurrences but were recurrent evolutionary crises or “periodical paroxysms” of speculation. The prime manifestations of such crises were “bubble companies”. The Report of the Gladstone Committee classified these companies into three classes: those faulty in nature; those ill-constituted and those fraudulent in object. Publicity via the prospectus was the answer to faulty companies since it would enable those “professionally employed in making investments to learn more easily and accurately the real nature of these companies”. Ill-constituted companies were best regulated by continuous disclosure and increasing the responsibility of company officers. Fraudulent companies could be best regulated by simple disclosure: the publication of the names of the directors, deeds of settlement, the amount of capital, and other pertinent information would, it was thought, “baffle every case of fraud” inasmuch as the public would have “the means of knowing with whom they were dealing.” Disclosure then, is the trade-off for the privilege of limited liability. On one view, limited liability with disclosure is the apex of classical evolution-to-efficiency because it represents the optimum balance between managers and investors as these groups became distinguishable. An alternative view is that limited liability itself is the evolutionary apex and that disclosure is the response to chaos; those initial conditions that might derogate from the efficient operation of limited liability.

69 Id., 5.
70 Id., 94.
71 Ibid. Note how this statement anticipates aspects of the twentieth century debate on the effectiveness of disclosure by prospectus. For example, “The concept that a prospectus enables the investor to act in informed fashion without professional aid is a delusion.” H. Kripke, “The SEC, the Accountants: Some Myths and Some Realities” (1970) 45 New York University Law Review 1151, 1165.
72 Hunt, op. cit., 93.
73 Ibid. Hunt summarises the Gladstone Committee’s recommendations as follows: “The Committee’s recommendations, then, were directed towards preventing ‘the use of Joint Stock Companies as mere instruments of share-jobbing’; in sum, to the establishment of means to insure: (1) sound regulations for the constitution of companies at promotion; (2) publicity throughout the whole course of proceedings.” Id., 94.
The Classic Legal Genealogy: 1844 to 1962

The classic rationale for securities regulation in English law is to prevent fraud and protect investors via disclosure.74 This rationale appears in the reasoning of various Parliamentary Committee Reports between 1844 and 1962 designed to study company legislation. These are discussed below. The period 1844 to 1962 was chosen for several reasons. Before 1962, there was a clearly articulated legal philosophy for securities market regulation and no wide spread acceptance of the EMH. While the recommendations of reports in the period 1844-1962 did not always result in legislation they do depict the nature of the debate on disclosure. Fraud and consumer protection provided the central rationale for disclosure; there were no competing rationales during this period. The EMH was not developed until the mid 1960s.75 Full elaboration of the EMH did not appear until 1970 when Eugene Fama published his seminal review article.76

The Gladstone Committee Report

As stated, the First Report of the Select Committee on Joint Stock Companies was published in 1844 (the Gladstone Committee Report). This committee recommended measures - such as the registration of companies - that are now integral to modern corporate law. In the area of disclosure, the report introduced requirements for companies to provide shareholders with access to their accounts, balance sheets and auditors’ reports, details of their place of business and officers, the purpose of the company and available capital, deed of settlement, number and amount of issued shares and the present membership of the company.77

The committee was instructed to direct its inquiries “with a view to the greater Security of the Public” and noted it might achieve this end by reducing the potential

75 See Ronald J. Gilson and Reinier Kraakman, op. cit., 550.
for “bubble companies” to be employed for fraud. As we saw earlier, the committee identified three categories of “bubble companies”. The first of these categories (companies “faulty in their nature”) did not involve fraud, and the legislature considered it “beyond the certain cure of the legislature”. However, as part of its response to preventable fraud produced by the other two categories of bubble companies, the Gladstone committee proposed basic disclosure requirements. Thus, the committee stated that the “publication of the Directors, of the Deed of Settlement, of the amount of capital, and whether subscribed or not subscribed, nominal or real,” would “baffle every case of fraud” with respect to the third class of bubble company, viz., those that were “faulty, or fraudulent in their object”. Likewise, the reasoning behind the requirement for the “periodical balancing, audit and publication of accounts” was that “[p]eriodical accounts, if honestly made and fairly audited, cannot fail to excite the attention of the real state of a concern”. Together with improved remedies, such disclosure would allow action to be taken where companies fell into the second category of bubble company, i.e., companies “so ill constituted as to render it probable that miscarriages or failures incident to mismanagement will attend them”.

The findings of the Gladstone Committee have contemporary relevance. First, the committee thought that category one companies were “beyond certain cure by the Legislature”. All that disclosure could do was to control them at the outset through prospectus disclosure. Thus, there was early recognition that disclosure can only do so much; it cannot eliminate risk entirely. Secondly, as to the second and third class of company, it was assumed that disclosure would give the public the requisite

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78 Id., iii-iv. The direction of the inquiry is made clear by the evocative headings used for the evidence, which include ‘The modes of deception adopted’, ‘the amount and distribution of the plunder’ and ‘the circumstances of the victims’. Id., ix, x, xi
79 These categories being:
1stly, Those which, being faulty in their nature, inasmuch as they are founded on unsound calculations, cannot succeed by any possibility;
2dly, Those which, let their object be good or bad, are so ill constituted as to render it probable that miscarriages or failures incident to mismanagement will attend them;
3dly, Those which are faulty, or fraudulent in their object, being started for no other purpose than to create shares for jobbing in them, or to create, under pretence of carrying on a legitimate business, the opportunity and means of raising funds to be shared by the adventurers who start the company. See id., iv.
80 Id., v.
81 Id., v-vi, xii-xv.
82 Id., v.
83 Ibid.
84 Id., v-vi.
knowledge to make informed decisions. The assumption was always contentious and reminds us that mere disclosure is not enough. There must be “mechanisms of market efficiency” (to use Gilson and Kraakman’s phrase) that enable disclosed information to reach the investing public.

**Lord Davey’s Committee**

The next significant report dealing with the British disclosure regime occurred in 1895. The Board of Trade appointed a Departmental Committee “to inquire what amendments are necessary in the Acts relating to Joint Stock Companies incorporated with limited liability”.\(^{85}\) The Committee was directed to do so “especially with a view to the better prevention of fraud in relation to the formation and management of companies”.\(^{86}\) It recommended stronger disclosure requirements in prospectuses; greater disclosure of debts; more stringent standards for accounts; balance sheets and audits; and, the compulsory appointment of auditors and inclusion of certain particulars in company accounts.

The focus on fraud and protecting shareholders and those seeking to purchase shares was clear, but the needs of creditors were also considered. The Committee noted that “creditors as well as shareholders” are interested in the administration of companies and that “[t]heir interests while diverse are not necessarily adverse or in conflict”.\(^{87}\) Thus, the Committee stated that “both classes are interested in honest administration … and it is upon the honesty and capacity of the directors and manager that in the long run reliance must be placed”\(^{88}\) and sought to provide recommendations for ways in which legislation could assist. At the same time, this report stated that it was not the place of the government to protect those who act foolishly and noted the potential cost to business of regulation. The report stated:

> Before inquiring into the typical forms of fraud against which further protection is sought … it is convenient to consider shortly the general lines upon which and the limits to which the legislature can safely or usefully interpose. It is a trite observation that legislation cannot

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\(^{86}\) Ibid.

\(^{87}\) Ibid., para 7. The report also noted that those engaged in ‘speculation with a view to sale’ did not fall within the ambit of those the Committee believed should be protected.

\(^{88}\) Ibid.
protect people from the consequences of their own imprudence, recklessness or want of experience. The Legislature cannot supply people with prudence, judgment or business habits ... Restrictive provisions, which may have the effect of either curtailing the facilities for the formation of companies which bring so much business to England or of embarrassing the administration of companies ... are not to be lightly entertained. 89

As regards primary market offerings, however, the Davey Committee reasoned that “a person who is invited to subscribe to a new undertaking has practically no opportunity of making any independent inquiry before coming to a decision” and therefore “[t]he maxim of Caveat Emptor has ... limited application.” 90 In these circumstances, the Committee considered it was of the highest importance that strict protections be put in place. 91

**The Warmington Committee**

In 1905, relatively soon after the Report of Lord Davey’s Committee, the Board of Trade appointed a Company Law Amendment Committee with a similar purpose of investigating the law relating to Joint Stock Companies. 93 The attention of the Committee was ‘particularly directed’ to several of the matters previously raised in the Report of Lord Davey’s Committee in relation to fraud. 94 The Warmington Committee followed the approach of Lord Davey’s Committee. It stated:

> Convinced therefore of the beneficial operation of the present company system ... whilst it is desirable by all reasonable means to repress fraud, the utmost care should be taken not to unduly curtail the facilities and advantages under which honest enterprise has flourished. 95

The Warmington Committee’s view of protection against fraud was expansive. Taking a wider view of those requiring protection, it recommended changes for the

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89 Ibid.
90 Id., paras 5 and 6.
91 Ibid.
93 Id., para 1.
94 Ibid.
95 Id., para 8.
protection of persons who may deal with a company, and who may become its creditors, such that “every limited company should be required to file periodically a statement of its affairs in the form of a balance sheet.” While Lord Davey’s Committee considered the protections needed by creditors, this report extends its consideration to the interests of potential creditors, a much wider group. An argument in relation to private companies (that as “they do not appeal to the public for subscriptions, there is no need for publishing their private affairs”), was specifically rejected based in part on concerns that “private companies are just as likely to be insolvent as public companies”.

Here, the goal of preventing fraud has evolved from specific concern with the crime of fraud appearing in the Gladstone Report towards a wider protective purpose.

*The Wrenbury Committee*

The next report dealing with disclosure was prepared by the Company Law Amendment Committee, chaired by Lord Wrenbury, in 1918. This committee was directed to consider what amendments to the Companies Act might prove expedient, particularly given the war and its conclusion. The report itself was comparatively brief, and only a few paragraphs addressed disclosure. Nonetheless, the underlying importance of fraud and the protection of the public remain clear. For example, in its discussion on extending disclosure requirements to private companies, the committee stated “the private company might no doubt be used for fraud” even if “there is no evidence before us that it is so used”. Likewise, in several other places where the committee declined to recommend an extension of the law, it based its decisions on the absence of “any sufficient grievance or mischief”. These statements indicate that the rationale behind disclosure remained a protective purpose.

*The Greene Committee*

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96 Id., para 33.
97 Id., para 46.
99 Id., para 1.
100 Id., para 63.
101 Id., para 64.
In 1926, a report was prepared by the Company Law Amendment Committee, chaired by Wilfred Greene KC. The review undertaken by the committee was intended to be wide-ranging and comprehensive. To this must be appended a caveat. The report stated:

We consider that in general it [the system of British company law] fulfils this object [the needs of the community at large and the commercial community in particular] in a highly satisfactory manner. It is a system well understood by those who have to deal with it; it has stood the test of years, and in our opinion should not be altered in any matter of principle except where this alteration is imperatively demanded.

Thus, in this report, the negative consequences of enhanced regulation are emphasised. While it considered the need to protect against fraud and other abuses, the Greene Committee accepted the operation of the existing system provided adequate protection in most areas and change posed a risk of unintended negative consequences. The Committee noted that “many of the suggestions made to us show that the idea that fraud and lesser malpractices can be stopped by the simple expedient of an act of parliament dies hard”. More significantly, it accepted that certain types of fraud should be tolerated, even where a legislative remedy might exist, as “the price the community has to pay for the advantages of a system so beneficial to trade and industry.” The Committee was reluctant to change the existing law even where the rationale of preventing of fraud offered some justification.

The Cohen Committee

By the time of the Cohen Committee report dealing with disclosure in 1945, profound economic and political shifts had taken place in the United Kingdom, resulting from amongst other things - the experiences of the Great Depression and World War II. In

103 Id., para 1 and 2.
104 Id., para 6.
105 Id., para 7 and 8.
106 Id., para 10.
107 Id., para 6 and 10.
108 Id., para 9. This theme is repeated elsewhere in the report. It was thought that some suggestions for the prevention of fraud would place ‘quite intolerable fetters on upon honest business’ and ‘undue interference by the legislature … is to be avoided, even if some risk of hardship in individuals cases is involved.’ See id., paras 8 and 71. Concern about excessive regulation was raised in every committee report discussed herein.
In this context, the Committee on Company Law Amendment chaired by Lord Cohen was instructed once again to identify any desirable amendments to the Companies Act. In particular, it was asked to consider “the safeguards afforded for investors and for the public interest” in company law. In fulfilling this instruction, the Cohen Committee made recommendations on a number of areas relevant to disclosure including: increasing the reporting requirements of private companies; imposing stricter standards on the inclusion and presentation of information in the company accounts, and making disclosure available to a wider audience.

The rationale for change evolved markedly from that presented by the Greene Committee. However, the evolving rationale did not involve a shift from the prevention of fraud as the primary justification for disclosure. The committee concisely stated its reasoning for disclosure as follows:

[I]f there is any flexibility, opportunity for abuse will inevitably exist. We consider that the fullest practicable disclosure of information concerning the activities of companies will lessen any such opportunities and accord with a wakening social consciousness. Accordingly, while … we have borne in mind the importance of not placing the fetters upon business … we have included a number of proposals to ensure that as much information as is reasonably required shall be available both to the shareholders and creditor of the company concerned and to the general public.”

The Cohen Committee had a wider understanding than the Greene Committee of what measures would not unduly fetter business. Moreover, the Cohen Committee took an expansive view of who should be protected by disclosure and the wrongs against which protection was provided. As we see in the above quotation, the report of the Cohen Committee speaks of disclosure as protecting the public and the public interest, as opposed to merely shareholders or creditors. In its examination of private companies, the Report even notes that the exemption enjoyed by these companies from certain of the disclosure provisions “deprived … trade unions of information

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111 Id., para 5.
112 The repeated references to public interest must be understood in context. There does appear to have been a movement towards a broader understanding of those who needed protection. However, in several places the references to the public interest do not deal with concepts similar to modern notions of consumer protection but with central planning and control of important aspects of the economy by the government. This was, in part, due to the much expanded role of the government in the post-war period.
which they need to assess the justice of wage rates offered by employers”.113 Likewise, the Cohen Committee view of fraud was much closer to present ideas of consumer protection than the comparatively restricted concept found in previous reports. Hence, the Committee “sought to find means of making it easier for shareholders to exercise a more effective general control over the management of their companies”.114 However, the Committee rejected secret or undisclosed reserves,115 not merely as they could deceive investors, but also on the basis that they undermined public confidence in the market and placed directors in an “invidious position” when dealing in companies’ shares.116 In summary, the Cohen Committee Report saw disclosure as being protective in purpose, but displayed a wider understanding of what and who was being protected.

**The Jenkins Committee**

After the Cohen Report and the significant legislative changes made in response to its recommendations, the next report dealing with disclosure was delivered in 1960. The report, prepared by the Company Law Committee chaired by Lord Jenkins, was given wide terms of reference with no qualifications regarding disclosure.117

The Jenkins Committee noted that the changes resulting from the Cohen Report were generally agreed to have “improved in many respects the law as it previously stood” and “on the whole, worked well in practice.”118 Thus, while observing that “there are many questions, of sufficient importance to merit legislative attention, left unresolved by the Act of 1948”,119 the Jenkins Committee expanded upon, rather than revising, the recommendations advanced by the Cohen Committee. It was more reluctant to change a system that was generally praised than the Cohen Committee was to change

114 Id., paras 5 and 7.
115 Id., paras 101 and 102. The term “secret reserves” refers to the then common practice of companies using various accounting technique to create a store of funds that were not included in the accounts. This practice was justified on the basis that companies required a reserve in order to maintain dividends and investment even in the event of short-term financial difficulties.
116 Id., para 101.
118 Id., para 7.
119 Id., para 9.
one seen as outmoded. Hence, the committee adopted the same protective rationale for disclosure, and corporate regulation generally, asserting in its Report that:

It is no doubt necessary for the protection of shareholders, creditors and intending investors that the activities of companies and those responsible for their management be subject to a considerable degree of statutory regulation and control.

More specifically on the reasoning for disclosure, the Committee stated:

…we share the views of the Cohen Committee as to the importance of ensuring that companies should make available to creditors, shareholders and the general public as much information as is reasonably required.

In these quotations and elsewhere, the Jenkins Committee adopted the Cohen’s Committee’s broad understanding of those whom disclosure protected. Thus, even as the rationale for disclosure developed towards its modern form, the EMH had yet to appear.

The Classic Legal Genealogy after 1962

It should not be assumed from the preceding section that modern prospectus disclosure was a feature of the nineteenth century Companies Act. It was not until 1900 that companies which issued prospectuses were required to file copies of them at the Companies Registry. Further, until 1985, the degree of disclosure under company legislation in the United Kingdom was less than that required by the Stock Exchange listing rules. More generally, laws contained in company legislation are of a collective nature and protect the rights and interests of all shareholders or a class

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120 The Committee displayed a marked ambiguity towards extending the law. See id., para 14.
121 Id., para 11.
122 Id., para 13.
123 Note that the Jenkins Committee makes much less extensive reference to the public interest than the Cohen Committee. The Jenkins Committee, however, still refers to the general public as a protected group.
124 Note the discussion of the exemption of shipping companies from certain disclosure provisions. Here, the Committee identifies potential harms: ‘… that shareholders are deprived of knowledge that would allow them to form a fairer view of the value of their investments, that they prejudice the bargaining position of employees and that they make it possible to conceal the inefficiency of management’ Id., para 414. While the first reason may appear to resemble EMH concerns, the committee is really concerned with possible unfairness and harm to individual shareholders not any impairment to the efficient operation of the market.
125 The earliest comprehensive statute imposing mandatory disclosure requirements was the Companies Act, 1900 (UK), 63 and 64 Vic., c. 48, section 10 (1). See the discussion in Pennington, op.cit., 31.
126 Ibid.
of them. While there may be an overlap with the rights of individual investors, this is not always the case. Thus:

When legislation is drafted to protect the rights and interests of shareholders as investors, it is … their individual rights and interests which are in question, and it is purely fortuitous whether other shareholders have been adversely affected … Subscribers for shares under a false or incomplete prospectus … each have an individual grievance, and it is immaterial that there are several of them with the same grievance arising out of the same circumstances. Legislation regulating conduct on investment markets is intended to provide for, or to prevent, such individual grievances … the proper protection of individual investors’ interests according to their status is something quite different from the purposes underlying the Companies Acts …

This is the reasoning behind the first two discrete statutes dealing with investor protection in the United Kingdom: the Prevention of Fraud (Investments) Act 1939 and the consolidating Act of the same name of 1958. As the title of the two Acts suggests, they were aimed squarely at fraud. The 1939 Act was passed after an outbreak of fraudulent securities transactions in the early 1930s, reported on by the Bodkin Committee. Pennington thinks the 1939 and the 1958 Acts had a limited impact on the markets for investments. Subsequently, Professor Gower was commissioned to review the law of investor protection. This review led to the first “stand alone” securities regime in the United Kingdom; the Financial Services Act 1986.

A useful chronological listing of all United Kingdom company law reports in the period 1895 to 2004 appears in the company law text by Hicks and Goo. In the period after 1962, however, I shall mention only two items: Gower’s, Review of Investor Protection (the Discussion Document) published in 1982 and the Financial Services and Markets Act 2000 (UK).

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127 Id., 33-34.
128 Cmnd. 5539 of 1937.
129 Id., 44.
130 For a review, see id., 49-101.
Gower was commissioned by the Secretary of State for Trade in July 1981 to undertake a review considering, inter alia, the statutory protection required by private and business investors in securities. Gower’s Discussion Document begins by asking: why is it necessary to protect investors? The laissez-faire view, says Gower, is that investment entails risk and the investor should realise this and not expect any special protection over and above the general law of theft and fraud. The laissez-faire view is – of course – the null hypothesis so beloved of the economists. Here is Gower’s reply:

[This robust affirmation of laissez-faire principles has long since been rejected and it has been recognised that it is the investors’ own fault only if they were in a position to judge the extent of the risk. A variety of methods have been tried in an attempt to ensure that. The oldest is to provide for disclosure of information, with liability to criminal penalties and, perhaps, damages at the suit of the investor if the information was not truthfully disclosed. The weaknesses of that are that only sophisticated investors will be able to make an informed judgment on the information disclosed (others need professional advice), that even they will be endangered if the information is not truthful, and that a possible claim for damages against a culprit who may have disappeared or not be worth powder-and-shot is not what investors want or need. Moreover, it is of the nature of investments that their risk cannot be adequately assessed on the basis of existing information about them, since the risk depends too on the probity and skill of those who will in future be managing the investment. Hence disclosure has had to be supplemented by regulation …

Here, we observe further refinement of the investor protection rationale. First, notice the importance placed on investors’ ability to “judge the extent of the risk”. For example, one key reason for prospectus disclosure is to enable investors to make comparisons and to choose between competing offerings of securities in the primary market. Next, if offerings differ, so do investors. In the above passage, Gower draws a distinction between sophisticated and unsophisticated investors. This distinction now has wide currency in Western securities regulation regimes even if

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133 Id., 4.
134 Ibid.
135 “Deciding whether to buy or sell a security thus requires reliable information about such matters as the issuer’s financial condition, products and markets, management, and competitive and regulatory climate. With this data, investors can attempt a reasonable estimate of the present value of the bundle of rights that ownership confers.” James D. Cox, Robert W. Hillman and Donald C. Langevoort, op. cit., 1.
136 Id., 269-270.
its conceptual basis entails a paradox. One reason for the distinction is that share
market ownership has changed since the nineteenth century giving rise to a so-called
“equity culture” or “shareholder capitalism”. This refers to the phenomenon of large
direct and indirect equity ownership in some Western countries.

As stated, Gower’s Discussion Document was part of the process leading to the
Financial Services Act 1986 (UK). As a result of a series of scandals and crises in the
financial services area in 1997, the newly elected Labour Government under the
leadership of Tony Blair, announced that the 1986 regulatory system would be
abolished and a new single regulatory system established. It is commonly
acknowledged that the resultant Financial Services and Markets Act 2000 (UK)
(FSMA) was an ambitious task. Howard Davies stated:

… I note that it was a heroic endeavour to seek to reform the whole
basis of financial regulation, covering all sectors of the market, in one
go. I cannot think of another major economy in which that has been
done. Even those other countries which have established single
regulators have typically done so by administrative stitching together
of different bodies, leaving their separate underlying pieces of
legislation intact.

The Financial Services Authority (FSA) is responsible for administering FSMA. The
regulatory objectives of FSA are expressed in terms of market confidence, public
awareness, consumer protection and the reduction of commercial crime. As Blair
and Walker note, this is the first time that a “clearly articulated set of statutory
objectives has been imposed on a financial regulator in the UK.” Each of these four
objectives is elaborated upon by Blair and Walker. In short:

- *Market confidence* is concerned with maintaining confidence in the financial
  system;

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137 Id., 282 citing C. Edward Fletcher, “Sophisticated Investors under the Federal Securities Laws”
(1988) Duke LJ 1081, 1125-1126. The paradox - under the Securities Act 1933 (U.S.) - is that
unsophisticated investors who do not read prospectuses receive them while sophisticated investors
who read them do not.

Ferran and Charles Goodhart, eds, *Regulating Financial Services and Markets in the 21st Century*

139 Howard Davies, “Reforming Financial Regulation: Progress and Priorities” in Ferran and
Goodhart, op. cit., 17, 18.

140 Section 2 (2), FSMA.

141 Blair and Walker, op. cit., 15.

142 Id., 15ff. See sections 3-6, FSMA.
• **Public awareness** is concerned with promoting public understanding of the financial system, and, in particular, includes increasing awareness of the benefits and risks associated with the different kinds of investment or other financial dealings and the provision of appropriate information and advice;

• **Consumer protection** is concerned with securing an appropriate degree of consumer protection having regard to the differing degrees of risk involved in different investments or transactions, differing degrees of expertise and experience that consumers have, and the need for accurate information and advice to be given to consumers subject to the general principle that consumers are responsible for their own decisions, and

• **Reduction of commercial crime** is concerned with reducing the extent to which financial businesses may be used for purposes connected with financial crime (widely defined).

We see here a modern, sophisticated restatement of traditional concerns. As Blair and Walker observe:

Market confidence, awareness, and financial crime are all more immediately concerned with consumer protection rather than market stability as such. All of these could also be considered to fall within consumer protection more generally ... *It could be claimed that the effect of this is to transform the FSA principally into a consumer protection rather than a market stability agency.*

4. THE EMH AND BEHAVIOURAL FINANCE

In this section of the essay, I briefly review key tenets of the EMH and some of the new insights of behavioural finance. In 1970, Eugene Fama defined the EMH hypothesis by stating that an efficient financial market is one in which security prices always fully reflect available information. Securities markets are “weak form” efficient where share prices reflect historical prices; “semi-strong” efficient if prices reflect all publicly available information, and, “strong form” efficient if securities prices reflect all available information, public and private. The EMH is an economic model. Generally speaking, however, there was early empirical support for the weak

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143 Id., 16. Emphasis added.
144 See Shleifer, op. cit., for a summary of the EMH literature; see also Hersh Shefrin, op. cit.
and semi-strong form of the EMH. The EMH thus claims that real-world financial markets are efficient according to this definition. This is good news for investors in the secondary market. If the secondary market is efficient, share prices per se protect investors without the need for them to peruse company announcements and similar documents.

The first implication of the EMH for securities regulation is that the average investor cannot beat the market. There is no point in stock picking: individuals should hold an index fund or some other form of market portfolio. This implication is empirically contradicted by the rise in direct share-ownership in many OECD countries but empirically supported by indirect individual share-ownership where the relevant shareholding occurs via a market portfolio.

The EMH has been enormously influential. Shleifer says that “the field of academic finance … was created on the basis of the EMH and its applications.” Indeed, in 1978 Michael Jensen said that “there is no other proposition in economics which has more solid empirical evidence supporting it than the [EMH].” In hindsight, this remark was the high water mark of the influence of the EMH. By 2004, Jensen’s own views and those of others had been revised significantly.

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145 Shleifer, op. cit., 8.
146 Consider here the compulsory superannuation regime applying in Australia. The superannuation guarantee scheme was introduced in 1992 by the Superannuation Guarantee Charge Act 1992 and the Superannuation Guarantee (Administration) Act 1992. The scheme is administered by the Australian Taxation Office. Broadly, the superannuation guarantee scheme requires employers to make minimum superannuation contributions on behalf of their employees. The current employer contribution or “charge percentage” is 9 per cent of the employee’s quarterly earnings base. In 1992, when the scheme was introduced, the charge percentage was 3 per cent. To satisfy the requirements of the superannuation guarantee, contributions must be made into a complying superannuation fund or retirement savings account. A complying fund is one which complies with the Superannuation Industry (Supervision Act) 1993 and Regulations. Contributions to a non-complying fund will not normally satisfy superannuation guarantee requirements. Since July 2005, pursuant to the Superannuation Legislation Amendment (Choice of Superannuation Funds) Act 2004, employees may select an eligible fund to receive superannuation guarantee contribution made on their behalf. Superannuation guarantee amounts need to be remitted every quarter and complying funds qualify for concessionary tax treatment which acts as an incentive to channel funds into these products.
147 Shleifer, op. cit., 1.
As Shleifer notes, the basic theoretical case for the EMH rests on three arguments. They are as follows:

- Investors are assumed to be rational and hence value securities rationally;
- To the extent that some investors are not rational, their trades are random and cancel each other out without affecting prices;
- To the extent that investors are irrational in similar ways, they are met in the market by rational arbitrageurs who eliminate their influence on prices.\(^\text{150}\)

To set the scene for subsequent discussion, some difficulties with the theoretical case for the EMH which flow from the findings of behavioural finance are as follows:

- Investors are not fully rational. Some investors trade on “noise” rather than information;\(^\text{151}\) they do not pursue the passive strategies expected of uninformed market participants.
- The ways in which investors deviate from economic rationality are pervasive and systematic. Shleifer categorises these ways into three main areas: attitudes to risk such as loss aversion; non-Bayesian expectation formation (investor sentiment or noise), and, sensitivity of decision making to the framing of problems.\(^\text{152}\)
- The psychological evidence is that investors do not deviate from rationality in a random manner; \textit{most deviate in the same way}.\(^\text{153}\) This phenomenon has especial relevance to price bubbles such as the Internet bubble.
- Real world arbitrage is limited and risky.\(^\text{154}\) Here, a striking example is provided by the Enron debacle. If the EMH holds, why didn’t market professionals short-sell Enron stock?\(^\text{155}\)

Hersch Shefrin is regarded as one of the founders the behavioural finance movement. He thinks behavioural finance theories emerged when advances made by

\(^{150}\) Shleifer, op. cit., 2.


\(^{152}\) Shleifer, op.cit, 10.

\(^{153}\) Id., 12. Emphasis added.


The results on the average performance of these loser and winner portfolios … point to extremely high post-formation returns of extreme losers and relatively poor returns of extreme winners. This difference in returns is not explained by the greater riskiness of the extreme losers … An alternative explanation … is that stock prices overreact: the extreme losers have become too cheap and bounce back, on average, over the post-formation period, whereas the extreme winners have become too expensive and earn lower subsequent returns. This explanation fits well with psychological theory: the extreme losers are typically companies with several years of poor news, which investors are likely to extrapolate into the future, thereby undervaluing these firms, and the extreme winners are typically companies with several years of good news, thereby, inviting overvaluation.\footnote{Shleifer, op. cit., 18.}
Shefrin identifies three main themes in behavioural finance. He calls these heuristic-driven bias; frame dependence, and inefficient markets. These themes are now reviewed.

Heuristic bias refers to rules of thumb developed by trial and error. Behavioural psychology has identified the principles underlying these rules and the systematic errors associated with them. Thus:

- Availability bias describes the degree to which information is readily available. A rule based on this principle is called the availability heuristic. If, for example, newspapers report more deaths by homicide than death by stroke, then persons who employ the availability heuristic may think that more people die by homicide than stroke.

- The representativeness bias refers to judgments based on stereotypes. An application of this heuristic tends to ignore regression to the mean. An example is the winner-loser effect documented by De Bondt and Thaler and discussed above. Discounting the impact of regression to the mean as a result of representativeness may manifest itself in the gambler’s fallacy (sometimes called the Monte Carlo fallacy) which misinterprets the law of averages (the law of large numbers). This bias is often cited as an explanation for the Internet bubble.

- Related heuristics are overconfidence, anchoring-and-adjustment and conservatism, aversion to ambiguity and the link between emotion and cognition.

A second theme of behavioural finance is frame dependence. Shefrin describes the theme in the following terms:

The form used to describe a problem is called its frame. When I speak of frame independence, I mean that form is irrelevant to behaviour. Proponents of traditional finance assume that framing is transparent. This means that practitioners can see through all the different ways cash flows might be described. Yet many frames are not transparent but rather are opaque. When a person has difficulty seeing through an opaque frame, his decisions typically depend on the particular frame he

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163 See Shefrin, op. cit, Chapters 2-4.
164 Id., 18-22.
uses. Consequently, a difference in form is also a difference in substance. Behaviour reflects frame dependence.\textsuperscript{165}

A good example of frame dependence is “loss aversion”. Kahneman and Tversky’s work on prospect theory provides evidence of frame dependence. The question here is: how do people respond to the prospect of loss? When given a choice between a guaranteed loss and a chance, most people opt for the chance because they do not like to lose. Kahneman and Tversky call the phenomenon loss aversion and find that it has two and a half times the impact of a gain of the same magnitude.\textsuperscript{166} As a consequence, people prefer frames that obscure losses and engage in hedonic editing.

Loss aversion suggests a powerful rationale for the prohibition on insider trading. Any perception that insider trading takes place may make losses appear as inevitable to investors. As a consequence they may prefer not to participate in the market in order to avoid making losses. A prohibition on insider trading removes a psychological barrier to market participation. As a result, more individuals will be inclined to participate in the market thereby increasing liquidity and efficiency.\textsuperscript{167}

We have already touched on the third theme of behavioural finance: the inefficiency of markets. Shefrin argues that this theme is related to the previous two themes by cause and effect. In his view, heuristic-driven bias and frame dependence cause prices to stray from fundamental values.\textsuperscript{168}

5. CONCLUSIONS
Reasons for requiring disclosure were first developed by lawyers in the context of securities fraud. Initially, disclosure was seen as a means of dealing with these specific kinds of information failure. It was assumed that disclosure of material information would erode the promotion of fraudulent schemes and hence protect investors. The mandatory disclosure of material information also had a deterrent

\textsuperscript{165} Id., 23.
\textsuperscript{166} Id., 24.
\textsuperscript{167} My colleague, Keith Kendall, proposed this argument in a draft chapter of his SJD thesis at La Trobe University.
\textsuperscript{168} “Three examples are: (1) representativeness as a cause of the winner-loser effect; (2) conservatism as a cause of post-earnings-announcement drift; and (3) mental accounting as cause of a historical equity premium that has been too high relative to the underlying fundamentals.” Shefrin, op. cit., 42.
function: it was thought that sharp practices would be curtailed since the relevant actors would be aware of the possibility of scrutiny. So from 1844 onwards, United Kingdom company law evolved to require the disclosure of new types of information by companies. This evolution can be viewed in “spread sheet” format in the two volumes edited by J. R Edwards, *British Legislation and Company Accounts, 1844-1976*.

In an incremental progression, law developed a disclosure philosophy long before the EMH or any other finance theory appeared. Viewed this way, the EMH is an ex post rationale for a disclosure philosophy developed by lawyers. Further, leaving aside continuous disclosure rules, there is little in modern securities regulation (outside of the United States) that relies on the EMH.

A modern view of disclosure requirements in securities regulation encompasses a broad span of information disclosure in order to provide investors with the means to protect themselves. This view does not necessarily assume the investor is rational. It does seek to ensure that he or she has an informed choice. Where the investor has the means of making an informed choice, it is immaterial whether or not he or she chooses to protect his or her interests. The investor has the right to act irrationally or make a fool of him or herself. This view of the purpose of disclosure has a related benefit in that it combines investor protection with freedom of enterprise.

The EMH in the semi-strong form neatly intersects with traditional legal thinking on disclosure because it holds that, in a well-functioning market, the prices of securities will reflect all publicly available information. The relevant information can be information contained in a legally compelled disclosure or a newspaper. To the extent that the information is legally compelled, the goals of the law and the EMH are congruent. It is precisely this reasoning that leads to calls for more legally compelled disclosure.

Leaving aside the mandatory-voluntary disclosure debate, here are at least two strong objections to calls for increased mandatory disclosure. The first objection derives from the EMH itself. This argument says that it is not the provision of information per se that is the crucial part of the EMH but rather the “mechanisms of market

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170 See Paredes, op. cit., 421ff.
efficiency” that relay information to investors. The EMH itself, after all, has been described as “absolutely accurate and totally useless”.\textsuperscript{171} Addressing precisely this point, Gilson and Kraakman observe that the “availability of information is a function of its distribution among traders in a given market”.\textsuperscript{172} They then identify the mechanisms by which new information is incorporated into securities prices: universally informed trading; professionally informed trading; derivatively informed trading and, uninformed trading.\textsuperscript{173} These mechanisms are the missing part of the EMH puzzle. On this view, mandating the disclosure of more information is not necessarily the answer. Rather, the answer resides in ensuring that information transmission operates effectively. Jonathan Macy has analysed the Enron collapse from this viewpoint. He states:

The Enron collapse demonstrates, however, that the “sunlight” that disclosure brings about is useful only if market mechanisms are in place that are capable of observing and interpreting the information that the “sunlight” brings into view. And this is true regardless of whether disclosures are made voluntarily or subject to a mandatory disclosure regime.

In other words, disclosure is a necessary but inefficient condition to accomplish the objective of ensuring that market prices are efficient. There must also be in place an adequate infrastructure to receive, analyse and interpret the information that is disclosed …

In the Enron collapse, the U.S. mandatory reporting system worked fairly well … Enron did make disclosures that should have led reasonable market participants to uncover grave problems within the company. Thus, the corporate governance problem that Enron unmasked was not a problem with the controversial U.S. system of mandatory disclosure. Rather, the problem was that the market did an astonishingly poor job of both interpreting Enron’s disclosures and “decoding” the information contained in trades by the Enron insiders.\textsuperscript{174}

Macy’s analysis suggests that a liberalisation of restrictions on short-selling would provide a useful legal mechanism to enhance market efficiency in the United States.

\textsuperscript{171} Gilson and Kraakman, op. cit., 552.
\textsuperscript{172} Id., 558.
\textsuperscript{173} Id., 566.
\textsuperscript{174} Macy, op. cit., 331.
A second objection to more mandatory disclosure is that market participants are subject to information overload. Building on Herbert Simon’s work on bounded rationality, Troy Paredes thinks that, to the extent that securities market participants are subject to information overload, the model of mandatory disclosure that “says more is better than less is incomplete and may be counterproductive”.\textsuperscript{175} Indeed, Paredes thinks that one implication of information overload is that the U.S. mandatory disclosure system might be more effective if it were scaled back (sunlight can be blinding). This argument also raises cost-benefit questions. Of course, this is not an argument against mandatory disclosure per se. There is good and compelling evidence to support the case for mandatory disclosure levels, especially in countries like Hong Kong that have concentrated ownership structures.\textsuperscript{176}

Where does the behavioural finance literature fit in this narrative? Gregory La Blanc and Jeffrey Rachlinski face the issue squarely. They state:

> Either irrationality among investors is so chronic and persistent that it causes assets to be mispriced or it induces individual investors to make such bad decisions that they are driven out of the market. In either case, irrationality is costly and should be curbed, if possible. If it affects prices, it is causing capital to be allocated inefficiently. If it does not affect prices but does consume individual investors, then individuals are hurting themselves – possibly risking their retirement savings as a result of their irrationality. If so, then possibly individuals should be saved from themselves.\textsuperscript{177}

La Blanc and Rachlinski offer a neat solution to the rational-irrational investor problem. They think investor irrationality has hidden benefits. On this view, markets are largely efficient but sometimes inefficient. They observe:

> Efficient markets persist in spite of individual investor irrationality, and indeed may be served by investor irrationality. We make three observations that support this thesis: (1) investor irrationality might be critical for liquidity; (2) investor overconfidence encourages investors to provide information to the market that would otherwise be withheld, and (3) the collective set of errors that individuals bring to the market

\textsuperscript{175} Paredes, op. cit., 419; Gladwell, op. cit., 175ff.
\textsuperscript{177} La Blanc and Rachlinski, op. cit., 543.
leads to a more efficient price than a market run by institutional investors.\textsuperscript{178}

The first proposition needs redefining. So-called “noise traders” provide liquidity but it is no means clear that they are critical to liquidity. Even if they were, the policy question remains: is the benefit of liquidity worth the social costs of not protecting irrational investors? The second observation seems insubstantial: what useful information are irrational investors providing the market? The answer is, very little. The third observation suffers from the same objection as the first; we get a more efficient price but at what cost? There is, however, one (and previously well-known) lesson we can take from their argument - markets may be efficient and inefficient at the same time.

Should we regulate to save irrational investors from themselves? The extant literature is equivocal. Peter Huang suggests “cautiously paternalistic or asymmetrically paternalistic regulations, namely, regulations that greatly benefit people who are prone to mistakes but only slightly … hurt people who are not prone to mistakes.”\textsuperscript{179} Donald Langevoort reviews fraud on the Internet, the “analysts’ privilege” (selective disclosure) and fraud on the market to suggest that the behavioural insights thus far point in a pro-regulatory direction.\textsuperscript{180} Lawrence Cunningham is quite sure that behavioural finance furnishes a positive theory of market behaviour carrying substantive normative implications for securities regulation.\textsuperscript{181} La Blanc and Rachlinski make a set of specific regulatory proposals including: structuring retirement savings to favour collective investments; the making of investment choices via professionals; curtailing of Internet investing; investor education programs; and, heightened scrutiny of “puff” advertising.\textsuperscript{182} I make three points about these proposals.

First, any regulatory proposals must be jurisdiction specific, taking into account the wider historical and economic context. What works for Australia may not work for

\textsuperscript{178} Id., 565-566.
\textsuperscript{179} Peter Huang, “Regulating Irrational Exuberance and Anxiety” in Parisi and Smith, op. cit., 501, 524.
\textsuperscript{180} Langevoort, op. cit., 187.
\textsuperscript{181} Cunningham, op. cit., 837.
\textsuperscript{182} La Blanc and Rachlinski, op. cit., 543.
Hong Kong.\(^{183}\) Second, most of these proposals involve little more than an extension
of existing initiatives based on investor protection considerations (eg, investor
education programs on stock exchange and regulators’ websites). Third, as to “puff”
advertising and similar statements: following a cognate provision – section 52 of the
Trade Practices Act, 1974 (Cth) - section 1041H of the Corporations Act, 2001 (Cth.)
now contains a prohibition on misleading or deceptive conduct or conduct which is
likely to mislead or deceive in relation to a financial product. The well-developed
case law on section 52 of the Trade Practices Act is directly relevant to the
interpretation of section 1041H.\(^ {184}\) There is no mental element in section 52. The
question is simply an objective interpretation of the facts: was the conduct misleading
or deceptive or likely to mislead or deceive? Significantly, however, section 52 has a
much lower threshold for evaluating conduct. So, for example, in *Annand &
Thompson Pty Ltd v TPC* (1979) ATPR 40-116 at 18272, Franki J. said:

> The question is to be tested by the effect on a person, not particularly
intelligent or well informed, but perhaps of somewhat less than
average intelligence and background knowledge although the test is
not the effect on a person who is, for example, quite unusually stupid.

In *ASIC v National Exchange Pty Ltd* [2003] FCA 995, the Federal Court of Australia
found that the defendant contravened section 1041H of the Corporations Act, 2001
(Cth) by representing in written offers to purchase shares in Onesteel Ltd that the
offer price was payable in full upon acceptance of the offers whereas the price was
payable in fifteen annual instalments. In describing the effect of the conduct on the
5000 identifiable Onesteel shareholders to whom the offers were sent, Finkelstein J.
stated:

> It is, however, appropriate to proceed on the basis that the shareholders
who received the offer include the educated as well as the uneducated,
the thinking as well as the unthinking, the credulous as well as the
cautious. Moreover, given their likely diversity, it is reasonable to act
on the basis that many shareholders will not weight each word of the
offer as an educated or analytical mind might do.\(^ {185}\)

After finding that a number of shareholders would have wrongly formed the view that
they were getting a cash offer for their shares, Finkelstein J said:

\(^{183}\) See the discussion of the characteristics Hong Kong market in Fong-Hsu et al, op. cit., 22ff.
\(^{184}\) See *National Exchange Pty Ltd v ASIC* [2004] FCAFC 90.
\(^{185}\) At para 12.
I accept that there may be shareholders who did not stop to analyse the offer in detail, and were only influenced by the general impression of the offer document. It is that impression which is misleading, though the offer contains no specific false statement. That is enough to establish a contravention of section 1041H. The section is not there for experts; it is there to protect the general shareholding public, many of whom do not analyse offer documents in any great detail, but act on appearances and impressions. This cannot be characterised as unreasonable conduct on their part. It is just the natural order of things.\textsuperscript{186}

The reference to the “natural order of things” (fallible humans) in the judgment is – of course – very close to descriptions of irrational investors in the behavioural finance literature. To this extent, the law - at least in Australia - recognises this category of investor and is a logical extension of the investor protection rationale in securities regulation. In the result, section 1041H has the potential to provide some degree of comfort for an aggrieved irrational investor in an appropriate case. Where such investors form an identifiable class, the High Court of Australia’s recent relaxation of litigation funding law will provide further assistance.\textsuperscript{187}

This leads to a related but neglected point. The practical outcomes of finance theory are uncertain.\textsuperscript{188} One of the fundamental capabilities of law, however, resides in its ability to manage uncertainty.\textsuperscript{189} At a general level, this capability is supplied by the case law method of decision-making. In part, this technique is an evolutionary mechanism and in part a technique that requires courts to work out rules that appear to work in most situations of the kind likely to be covered by the given rule. Thus, the law employs a “rules of action” approach under which policy or principles are formulated in the form of rules based pragmatically on a sense of what works in practice. These rules are adjusted or abandoned from time to time in light of experience. In this way, law manages “real world” uncertainty.

\begin{footnotesize}
\begin{enumerate}
\item At para 20.
\item The High Court of Australia, in a five-member majority decision, recently liberalised the law relating to the litigation funding industry. See \textit{Campbells Cash and Carry Pty Ltd v Fostif Pty Ltd} [2006] HCA 41. For comment, see \textit{The Australian}, August 31 2006, 23. It is expected that state and territory governments in Australia will harmonise their laws relating to third-party funding of litigation (including champerty and maintenance), while states that have not yet abolished such laws are likely to do so. See \textit{The Australian Financial Review}, 1 September 2006, 57.
\item See Benoit Mandelbrot and Richard Hudson, \textit{The (Mis)behaviour of Markets} (New York: Basic Books, 2004).
\item I am grateful to Brent Fisse for suggesting these comments on how law manages uncertainty.
\end{enumerate}
\end{footnotesize}
In terms of possible regulatory responses, we can use a risk assessment matrix and scoring mechanism as a tool to suggest ways of responding to the concerns of behavioural finance.\(^{190}\) Depending on the policy settings of the particular jurisdiction (eg, a spectrum from laissez faire to economic paternalism), the matrix forces the policy-maker to ask questions about the consequences for citizens and the state in the event of the occurrence of the types of adverse consequences contemplated by behavioural finance.

**Table 1: Risk Assessment**

**Exposure x Probability x Consequence**

<table>
<thead>
<tr>
<th>Exposure</th>
<th>Probability</th>
<th>Probability</th>
<th>Consequence</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continuously</td>
<td>10</td>
<td>Most Likely</td>
<td>1.0</td>
</tr>
<tr>
<td>Frequently</td>
<td>6</td>
<td>Possible</td>
<td>0.6</td>
</tr>
<tr>
<td>Occasionally</td>
<td>3</td>
<td>Conceivable</td>
<td>0.3</td>
</tr>
<tr>
<td>Infrequently</td>
<td>2</td>
<td>Remote</td>
<td>0.1</td>
</tr>
<tr>
<td>Rarely</td>
<td>1</td>
<td>Inconceivable</td>
<td>0.05</td>
</tr>
</tbody>
</table>

**Table 2: Risk Score**

<table>
<thead>
<tr>
<th>Risk Score</th>
<th>Risk</th>
<th>Immediate Action</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;8</td>
<td>HIGH</td>
<td>Immediate Action and Date Required</td>
</tr>
<tr>
<td>5-8</td>
<td>MEDIUM</td>
<td>Planned Approach Consider Temporary Measure</td>
</tr>
<tr>
<td>&lt;5</td>
<td>LOW</td>
<td>May be Acceptable Consider Controls</td>
</tr>
</tbody>
</table>

From a social policy perspective, the most significant concern raised by behavioural finance relates to retirement savings. One adverse impact of the Enron collapse was the effect it had on “tens of millions of holders of 401(k) and defined-benefit

retirement schemes".191 To the extent that such holders were forced to rely on social security or similar payments from the state for retirement, there is a compelling reason for state intervention. One solution, touched on earlier in this essay in the Australian context, is to mandate employer superannuation contributions into approved and state monitored superannuation funds.192 Such funds typically use portfolio selection principles that ensure risk spreading. Where such schemes are in place, it matters little if investors decide to risk disposable or other income on stock market gambles or other forms of “irrational exuberance” since a safety net is in place.

We can also use the risk assessment matrix to identify a hierarchy of risk. At the top (continuous risk, likely possibility and catastrophic consequences), we have risks such as the erosion of retirement savings. At the bottom, we have issues such as misleading and deceptive conduct. Higher order issues – such as retirement savings - involve large social policy questions. These are matters for political debate and resolution outside the particular securities regulation regime. Lower order issues can be addressed by careful extension of contemporary investor protection mechanisms (for example, misleading and deceptive conduct prohibitions) within the particular securities regulation regime.

The life of the law - as Justice Holmes reminds us - is not logic but experience.193 In securities regulation, we have a long and classic legal genealogy formed by the experience of market and investor behaviour which addresses two dominant concerns; fraud and investor protection. The history of this genealogy has not progressed in a smooth incremental fashion. Rather, we observe a process of “punctuated equilibrium” where the punctuations are represented by episodic crises (stock market frauds, “bubbles” and collapses of the Enron type).194 Overall, the law has proved sufficiently adaptable to meet these crises. Thus, modern formulations of investor protection in securities regulation can address the adverse consequences of those who invest on appearance and impression. It may come as news to those toiling in the

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192 Supra, n 146.
194 For Australia, see CCH Australia, Collapse Incorporated (Sydney: CCH Australia, 2001)
fields of behavioural finance but the law has a long history of dealing with human problems. It well knows that people are sometimes irrational – that is “the natural order of things”.