NEW ZEALAND BUSINESS ROUNDTABLE

Submission on the Review of the Securities Commission

February 1998

EXECUTIVE SUMMARY

- This submission on the review of the Securities Commission (the review) is made on behalf of the New Zealand Business Roundtable (NZBR).

- Efficient capital markets lie at the heart of the private enterprise system. Their regulation, including the role and effectiveness of regulatory agencies, is a significant public policy issue.

- A first principles examination of the Securities Act 1978 (the Act) and related regulation should be undertaken. There is a strong case to allow issuers and investors to choose either to opt into, or out of, any standard regulatory regime.

- The objective of securities regulation is to promote efficient securities markets. Efficiency should encompass allocative, productive and dynamic efficiency. Other objectives listed in the review are either redundant or conflict with efficiency.

- The most important issue discussed in the review is whether the Securities Commission (the Commission) should continue to play a leading role in securities law reform.

- The Commission's performance on policy development and law reform has been weak. It has consistently failed to apply valid public policy criteria to reform proposals and it has often ignored or misinterpreted recognised economic literature.

- The Commission's core role should be to administer the regulation of securities markets. Its activities should be tightly focused on this role.

- In our view the Commission should not have a primary role in policy development and law reform. It should advise on detailed legislative or regulatory matters relating to the administration of existing policy. The Commission should be consulted on the implementation and administration of new policy proposals.

- The Commission should not retain a general mandate to keep under review the law relating to bodies corporate.

- There are no persuasive public policy grounds for continuing to regulate futures exchanges, the rules of the New Zealand Stock Exchange, dealers in futures and sharebrokers.

- We are sceptical that a compelling case could be made for the mandatory appointment of trustees and statutory supervisors. If statutory supervisors are required to be appointed, the Commission is the appropriate body to authorise them. A less restrictive form of occupational regulation, such as certification, should be considered.

- The relatively heavy reliance on exemptions provides *prima facie* evidence that that the Act needs to be re-examined on a first principles basis.

- The general principle of issuing exemptions is endorsed. The existing process can be improved by prescribing the criteria for exemptions and presenting the reasons for exemptions in terms of those criteria.

- The Commission is the appropriate body to issue exemptions. We are advised that it is generally effective in undertaking this task.

- The Commission should restrict its monitoring and investigative activities to those securities matters for which it is directly responsible.

- The Commission should not exercise oversight over other government agencies.

- The establishment of self regulatory organisations with statutory powers is undesirable.

- Impediments to the private recovery of damages for breaches of the law should be addressed as a priority.

- While the Commission should provide general information to the public on the regulatory regime and the Commission's role, and respond to reasonable

enquiries about these matters, it should not promote New Zealand securities markets to New Zealand or overseas investors.

- The performance of the Commission should be subject to closer monitoring by the government.

- By focusing on its core role, exiting other roles and modernising its management practices, it should be possible to reduce the total spending of the Commission by at least 25 percent to not more than $1.6 million a year. Depending on the outcome of any general review of the Act, this amount could be reduced further.

- The Commission should fully fund the services that it provides from user charges or use-related charges where this is efficient. User-pays arguments apply in respect of both public and private goods. We think that about half the Commission's costs should be able to be funded from user charges.

- Our conclusions are presented in section 12.

1 OVERVIEW

1.1 This submission on the review of the Securities Commission (the review) is presented by the New Zealand Business Roundtable (NZBR). The purpose of the organisation is to contribute to the development of sound public policies that reflect overall New Zealand interests.

1.2 The NZBR's interest in the role and activities of the Securities Commission (the Commission) stems from its desire to promote policies that will enhance the efficiency of securities markets. As the minister of commerce states in the discussion document, these markets play a key role in allocating resources among alternative uses and they enable individuals to allocate consumption over their lifetimes. Efficient securities markets enhance economic performance. Their regulation, including the role and effectiveness of regulatory agencies, is a significant public policy issue.

1.3 The Securities Act 1978 (the Act)[1] is the principal statute affecting the issue to the public of securities such as new debt, equity and participatory securities, life insurance policies and interests in superannuation schemes, and new or existing interests in unit trusts. The range of securities affected by certain provisions of the Act was extended by the Securities Amendment Act 1996 to include retail investment products such as a new interest in a superannuation scheme.

1.4 The main thrust of the Act is to require issuers to disclose certain information to investors, especially before they commit their money. The Act also controls the content of advertisements that promote securities. These provisions are intended to provide information to assist investors to make informed decisions. The Securities Amendment Act 1988 regulates insider trading, the disclosure of

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[1] Reference to the Act includes amendments to the Securities Act 1978, notably the Securities Amendment Acts 1988 and 1996.

substantial holders of securities, dealers in futures, and a limited number of other activities.

1.5 The Act does not reflect contemporary perspectives on transaction costs, including information costs, efficient market theory, and the efficacy of regulation. The provision of more information does not necessarily raise consumer welfare because the costs incurred may exceed related benefits. Research since the mid-1960s casts doubt on the merits of much regulation of securities markets. The Act was adopted when financial markets were heavily regulated. Policy-induced barriers to entry into, and exit from, the financial services industry and controls on interest and exchange rates and international capital flows distorted the patterns of savings and investment.

1.6 The present investment environment is vastly different. As Benston (1997) noted in relation to investment product disclosure, New Zealanders can purchase securities offered by firms that are subject to US, UK, Australian, Japanese, Singaporean and other laws and regulations if they want the 'protection' and cost of these laws and regulations. The costs of transacting in another jurisdiction can be weighed against the benefits.

1.7 In addition to provisions in the Crimes Act 1961 and the common law discouraging fraud and misrepresentation, investors are afforded certain protections by the Fair Trading Act 1986 and the Consumer Guarantees Act 1993. The implications of these statutes for the Act have never been properly examined, although this task was assigned to working parties that examined the investment product and adviser disclosure proposals. The Financial Reporting Act 1993 has also been introduced since the Act was passed.

1.8 The extent to which our securities markets are regulated is commonly misunderstood. The 1991 Ministerial Working Group on

Securities Law Reform (Roche committee) comprising officials and private sector experts reported that:

> ... in certain key respects we have a framework of rules comparable to many overseas jurisdictions ... . It is ... misleading to characterise the New Zealand [securities] market as unregulated.

It observed that:

> ... following the recent wave of company collapses in Australia, the 'Wild West' tag has now been attached to Australian securities markets despite a regulatory framework that is much more prescriptive and activist than [that of] New Zealand.

The Roche committee also noted that:

> It is a recurring theme that a more extensive prescriptive regulatory regime is necessary to compete successfully for overseas capital. However, there is evidence pointing in the other direction – capital flows and trading activity respond more to too much regulation than to too little.

We share the Roche committee's assessment that:

> There is ongoing concern about [the] enforcement of our securities laws

and that in respect of market supervision:

> The focus of reform in this area should be on redefining the role (and powers) of the existing Securities Commission.

1.9 The Periodic Report Group (Todd, *et al.* 1997) observed that New Zealand has a relatively light-handed securities regulatory regime. It reported that even critics of the regime, such as Franks (1996), acknowledge that "among the countries with which we usually compare ourselves, New Zealand may have one of the least damaging securities regimes." However, the relevant issue for policy is not whether our regime is light-handed compared with the more highly regulated countries of North America, Europe and Australia but whether it is efficient (ie whether it makes the best possible contribution to the advancement of community welfare). Measured against this criterion, the present regime is deficient – just as low tariffs are damaging to an economy even though they may be less damaging than high tariffs.

1.10 An inefficient regulatory regime, including poorly performing regulatory and policy agencies, may restrict innovation and product development, put participants in New Zealand securities markets at a disadvantage internationally, increase the cost of capital and discourage growth. The increasing globalisation of capital markets and technological advances will limit the effectiveness of domestic regulation.

1.11 A first principles examination of the Act and related regulation should be undertaken. The aim of such a review should be to promote economic efficiency. Although the current review covers some aspects of the Act, such as whether traders in futures should continue to be authorised by the Commission, a comprehensive and searching examination is required. There is a strong case to allow issuers and investors to choose either to opt into or out of any standard regulatory regime. The Periodic Report Group's criticism that this would lead to undesirable regulatory arbitrage is mistaken. By allowing issuers and investors to choose, information would be generated on the marginal costs and benefits of different regulatory arrangements without withdrawing existing 'protections' from people who value them. Moreover, issuers and investors can already elect whether to be bound by the regimes of other jurisdictions. Regulatory arbitrage among jurisdictions is present now and is unavoidable.

1.12 The proposed examination of the Act should have preceded the review of the Commission. The role and functions of any regulatory agency that may be required should be decided once the optimal regulatory regime has been decided. It would be necessary to re-examine the role of the Commission as part of a broader review.

1.13 Our main reservations about the performance of the Commission arise from its role in policy formulation and law reform. In our view the Commission's advice has generally been inconsistent with the approach to regulatory issues that successive governments have

adopted since 1984 and with a contemporary approach to regulatory policy. The private sector has had to waste considerable amounts of time and resources rebutting the Commission's poorly conceived proposals. The Commission has never had the professional expertise to produce competent policy analysis and hence its work has been amateurish. There is no prospect of a small quango attracting resources of the necessary calibre, and this task is better handled by the competition and enterprise branch of Ministry of Commerce (the Ministry) [2], in conjunction with economic agencies such as Treasury. The Commission's regulatory functions lead to a legal/administrative bias and an apparent reluctance to consult internationally respected experts in finance or economics.

1.14 The Commission should focus on its core role which is the administration of regulation relating to the securities markets. It should play a minor role in policy formation and law reform. Given the existing regime, the scope of the Commission's responsibilities should be restricted to regulatory matters concerning the disclosure of information to investors. The regulation of corporate governance, for instance, which focuses on the relationship between a company and its members, should remain with the business and registries branch of the Ministry. The adoption of the super regulator model with either the Commission or the Ministry acting as the super regulator is not supported. Section 10 of the Act should be amended to reflect the tightly focused role of the Commission outlined in this submission.

1.15 With policy formation and law reform no longer being a main activity of the Commission, the level of taxpayer funding could be reduced. In addition, unnecessary regulation of activities and occupations should cease and user charges should be increased where efficient and feasible.

[2] Reference to the Ministry refers to its competition and enterprise branch unless otherwise indicated.

1.16 The balance of this submission is presented in eleven sections. The next section (section 2) discusses the objectives of the regulatory regime. Sections 3 to 11 discuss the issues raised in chapters 3 to 11 of the discussion document respectively. They focus on law reform (section 3), authorisation of participants and practices (section 4), monitoring and investigation (section 5), relationships with government agencies (section 6), enforcement (section 7), education and promotion (section 8), international liaison (section 9), accountability (section 10) and funding (section 11). Our conclusions are presented in section 12.

2 OBJECTIVES OF THE REGULATORY REGIME

2.1 The discussion document reports that:

> The objective of regulation of the securities markets in New Zealand is to promote markets which have the following characteristics:
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> a) little or no risk of suffering loss from dishonesty;
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> b) ready identification of the level of risk associated with investment;
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> c) low systematic risk;
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> d) an internationally competitive market; and
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> e) efficiency (ie an efficient allocation of resources) (p 7).

These objectives were originally proposed around 1991 by the Officials Group on Securities Market Supervision.[3] Although they do not seem to bear directly on the proposals contained in the discussion paper, it is important that public policy is informed by valid objectives. There are grounds for questioning the objectives listed. Typically regulation is justified on the grounds of efficiency or

[3] This group was formed after the Roche committee (Roche *et al.* 1991) reported. It is understood that it did not complete its report.

equity. Objectives (a) to (e) appear to be directed at efficiency in which case it is the sole objective. We concur with this objective.

2.2 The market system operates against a background of a legal structure that broadly divides activities into two categories: legal and illegal. Illegal activities include the use of fraud and misrepresentation. One interpretation of why these activities are illegal is that on a day-to-day basis the costs engendered by them considerably outweigh any benefits they may produce (Demsetz, 1990). While the government can declare certain activities to be illegal and employ resources to enforce its decision, it is unlikely to be economic to prevent all such activities even if that were feasible (Becker and Landes, 1974). From a public policy perspective an *optimal* level of resources should be committed to the deterrence of crime including the prosecution of offenders. This approach may be consistent with the objective of reducing dishonesty to low levels but it is unlikely to be consistent with the complete elimination of such risk.

2.3 The proposition that regulation should enable the level of risk associated with investment to be readily identified goes substantially further than current policy and, as a general proposition, conflicts with the efficiency objective. The Act, including the investment product and adviser disclosure rules, the Financial Reporting Act 1993 and the Companies Act 1993 (and its predecessor), reflect the view that government policy should mandate the disclosure of certain information to facilitate decision making by investors. The disclosure rules were promoted on the basis that investors should be able to compare different investments on a very general basis. They were not intended to enable the level of risk to be readily identified.

2.4 For some investments, for example an equity interest in wildcat oil exploration, it may be infeasible to readily identify the risk involved yet society benefits from such activities. Because investors can

diversify their investment the relevant issue for an investor may be the extent to which a possible investment would affect the risk pertaining to his or her portfolio rather than the level of risk associated with the particular investment. Moreover, vast resources are deployed privately to assess the risk of various investments. A more limited objective of regulating securities markets to provide an 'informed market' would also be of dubious merit for the reasons discussed by Benston (1997).

2.5 The view that securities regulation should produce markets with low systemic risk is also mistaken. Some special features of the bank settlements process may justify government action aimed at maintaining the solvency of the system as a whole. There are, however, no valid grounds for policy aimed at preventing the failure of a major player in the banking industry or in securities markets generally.[4] Present securities regulations are not directly aimed at lowering the risk of failure of a major or minor player. A regime that promises more than it can deliver may lead to inadequate information search by some investors and an expectation that the government will compensate investors for their losses if firms fail.

2.6 An efficient securities market may or may not be one in which New Zealand suppliers of financial services can compete successfully with foreign providers. International competitiveness depends on factors, such as whether New Zealand has a comparative advantage in financial services, that extend beyond the regulatory regime affecting the securities market. While unwarranted impediments or inducements to trade in financial services or capital flows would be inappropriate, the intent of objective (d) is best covered by the broader efficiency objective.

2.7 The view that an objective of regulation is to provide efficient securities markets is correct. Efficiency should be the only objective as other objectives, to the extent that they are desirable, are

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[4] See New Zealand Business Roundtable (1993) and Cowen (1991).

included in it. However, the efficiency objective should involve both allocative and productive efficiency. The latter obtains when it is not possible to produce more of any product or service that contributes to an individual's welfare without reducing the production of another commodity or service. At the firm level productive efficiency requires the adoption of least cost methods of production. Regulatory arrangements which prevent firms from minimising their costs without generating a commensurate benefit, for example because of unjustified barriers to entry into a particular occupation, are inconsistent with productive efficiency. If allocative and productive efficiency are broadly defined they lead to dynamic efficiency. This is where changes in the pattern of consumption and investment over time would not improve one person's welfare without diminishing that of another person.

2.8 We concur with the omission of equity from the objectives of securities market regulation. Questions related to the distribution of income are best addressed through welfare and tax systems.

3 LAW REFORM

3.1 In our view, the most important issue discussed in the review is whether the Commission should continue to engage in securities law reform and, if so, the extent of its involvement. Section 10(b) of the Act confers on the Commission an obligation "To keep under review the law relating to bodies corporate, securities and unincorporated issuers of securities, and to recommend to the Minister [of commerce] any changes thereto that it considers necessary". The Commission has allocated 27 percent of its budget for 1997/98 to law reform. In 1996/97 40 percent of the budget was spent on this activity to accommodate work on the investment product and adviser disclosure proposals.

3.2 In our view the Commission's performance on policy development and law reform has been lamentable. It has consistently failed to

apply valid public policy criteria to reform proposals and it has often ignored or misinterpreted recognised economic literature, including the findings of relevant research. The Commission was a key promoter of the law relating to the disclosure of substantial security holders in public issues, it has advocated controls on corporate takeovers, it was responsible for promoting the law on insider trading, and it was heavily involved in the development of the investment product and adviser disclosure proposals. All of these initiatives were misconceived and have led in some cases (eg insider trading) to law which is such a mess that it has frustrated supporters and opponents alike. The Commission produced three reports on takeovers each advocating a different policy stance. None contains a quality public policy analysis of the relevant issues and all of them were rightly rejected by successive governments from the early 1980s. The private sector has been required to commit vast amounts of time and incur hundreds of thousands of dollars of expenses to counter the Commission's poorly conceived policy proposals. Other government agencies, most of which also opposed the Commission's proposals, also had to devote considerable resources to dealing with them. Thus the real cost to the community of the Commission's law reform activities are far greater than is indicated by its budget.

3.3 The Commission's current discussion paper on Life Insurance Law and Practices again illustrates the problem. The paper does not contain a sound analysis of the issue from a public policy perspective. The central public policy issue is left until the last part (Part III) of the paper and is then evaded. The reader is advised that:

> A fundamental question in any regulatory review is whether there should be any form of regulation of the subject industry or activity at all. *The paper does not address that question. We believe the most useful way to consider life insurance regulatory issues at this time is in the context of already-regulated markets.* This brings into consideration some "level playing field" arguments as well as questions of the appropriate degree of regulatory input, if any, into various facets of companies' operations (emphasis added).

The Commission also reports that:

> We are aware there is extensive academic literature on the economics of regulation. We would expect any comprehensive review of the Life Act to have proper regard to the literature.

The paper does not, however, contain a single sentence summarising findings from that literature. Its conscious disregard of any fundamental economic analysis is a totally unacceptable basis for providing competent policy advice.

3.4 We believe our assessment of the performance of the Commission is widely shared. Successive governments have not generally relied on the Commission for leadership and expert advice on policy and law reform. Commission members have been appointed for their strengths in other areas. Similarly, staff with the competencies required to undertake quality policy development and law reform have not generally been recruited by the Commission. Moreover, the Ministry of Justice and its predecessor (the Department of Justice) which previously oversaw the Commission were poorly placed to advise on law reform for similar reasons. The Labour government sought to address the latter problem by establishing the Law Commission. The recent transfer of oversight for the Commission from the Ministry of Justice to the Ministry recognises that the former is poorly informed on commercial matters. The Ministry has built up its expertise in business law and we have more confidence that it better understands both the standards that should apply to policy analysis and the realities of business operations.

3.5 The Commission is not the only agency that has promoted unsatisfactory public policies relating to securities markets. The 1988 Ministerial Committee of Inquiry into the Sharemarket (the Russell Committee) and a series of reports by officials and working groups on investment product disclosure contain some of the most inadequate public policy analyses undertaken in recent years.[5] However, the Commission was involved in both these exercises and did not distance itself from them.

3.6 An objective assessment of the Commission's performance on law reform provides strong grounds for concluding that the responsibility for securities law reform should reside in another agency such as the Ministry. The following points reinforce this conclusion.

- Securities law reform should be the responsibility of an agency that has broad responsibilities for policy. This would facilitate the adoption of a consistent approach to policy across related areas. The agency should be committed to following a generic process for regulatory reform.
- Securities law reform activities need to be closely linked to policy formation processes as noted in the discussion document. The Commission is too remote.
- Quality public policy analysts are limited. The ability of organisations to attract, retain and monitor competent analysts may be limited when they are dominated by operational matters. The dispersal of capable analysts over many agencies is likely to lead to inadequately staffed policy units and to low quality proposals.
- The Commission's primary function should be related to the administration of the Act (section 10(a)). Law reform is bound to suffer relative to the requirement to undertake core activities.

[5] For a devastating critique of the Russell report see Franks (1996), footnote 4.

- The prime responsibility for the development of policy and its implementation has generally been assigned to separate agencies in recent public sector reforms. This approach is intended to avoid an excessively narrow approach to policy and to reduce the risks of regulatory capture. It would be unusual for a regulatory agency like the Commission to be assigned responsibility for policy development, the administration of related regulation and aspects of its enforcement. Conflicts of interest may arise. There are no reasons to depart from the standard approach to the division of responsibilities in respect of the regulation of securities markets.

3.7 There is, however, a need to retain a clearly defined link between the development of policy and securities law reform on the one hand and the administration of the regime on the other. New policies need to be capable of implementation. Practical experience may give rise to specific policy issues that should be addressed or should inform policy development. In addition, statutes and regulations need to be amended in the light of experience. Some of the information required to perform these activities is held by people engaged in the administration of the regulatory regime.

3.8 These considerations, together with the accountability of members of the Commission to the minister of commerce, suggest that the Commission's functions should include the following.

- A responsibility for advising the minister of commerce on specific legislative or regulatory issues affecting the implementation and administration of existing policy. This would include proposals to amend statutes or regulations *within existing policy*, for example to correct drafting difficulties and to reflect developments in the market. It would not include an extension of the existing regime to, say, life insurance. The proposed responsibility should be viewed as an aspect of the Commission's core administrative role.

The Commission rather than the Ministry is likely to have the relevant information to undertake this role effectively. The Commission should be permitted to consult interest groups (if necessary) on any changes. The Commission should put its proposals to the minister and through the minister to Cabinet. The prime role of the Ministry in respect of such proposals would be to confirm whether they are within existing policy.

- An opportunity to inform the minister of commerce of matters which arise from the application of the existing regime which, in the Commission's opinion, should be addressed in a wider policy context. It is not envisaged that the Commission would carry out detailed investigations on such proposals. Any such matters would normally be referred to the Ministry for investigation and, if appropriate, report on the same basis as other new policies. The responsibility for recommending whether policy should be changed would rest with the Ministry.

- A responsibility to assist with policy development and law reform when requested to do so by the minister. It is envisaged that this role for the Commission would be a minor one. However, it is appropriate for the Commission to be consulted on implementation and administration issues relating to proposed policies. The Commission's opinion or advice on other issues could be sought where warranted. In practice the Ministry would generally be responsible for initiating such consultation.

3.9 The division of responsibility for policy advice and law reform suggested above broadly reflects that between the Ministry of Transport and related regulatory agencies such as the Land Transport Safety Authority. While the distinction between existing and new policy is often unambiguous, there are issues that fall within a grey area. Both agencies would need to cooperate and

manage boundary issues constructively. The proposed responsibilities of the Commission would apply to a securities market regulator that undertakes the authorisation, exemptions, monitoring, investigative and enforcement functions listed in paragraph 125 of the discussion document.

3.10 The scope of section 10(b) of the Act should be narrowed. The Commission should focus on its core role – the administration of the regulatory regime for securities markets. It should not retain a general mandate in respect of the law relating to bodies corporate, such as the Companies Act 1993, which aims, among other things, to provide basic and adaptable requirements for the incorporation, organisation and operation of companies.

3.11 The development of high quality policy and law reform initiatives is likely to be enhanced by ensuring that policy analysis is reviewed by agencies that are capable of performing that role and is contestable in going forward to ministers. The economic policy agencies, particularly the Treasury and the Reserve Bank, should participate in the formation and monitoring of policy. In addition, open processes, such as the review of major proposals by internationally respected experts and genuine consultation with interested parties in the private sector, are essential.

4 AUTHORISATION OF PARTICIPANTS AND PRACTICES

4.1 The regulation of activities

4.1.1 The Commission currently regulates certain futures exchanges in terms of the Securities Amendment Act 1988. The Commission may declare a body corporate that conducts, or proposes to conduct, a market or exchange for the purposes of trading in futures contracts to be an authorised futures exchange. The New Zealand Futures and Options Exchange (NZFOE) is the only authorised exchange. As a condition of its authorisation, the Commission

approves the rules of the NZFOE and reviews clearing and settlement arrangements in respect of futures contracts. Electricity futures are not traded on an authorised exchange. The Governor-General in Council must approve the rules of the New Zealand Stock Exchange under the Sharebrokers Amendment Act 1981. The Ministry advises the minister on rules submitted by the exchange.

4.1.2 The issue of whether these regulatory arrangements should be retained is raised in the discussion document. It correctly notes the general move away from restrictions on entry into particular business activities and observes that protections afforded investors, aside from those provided by generic and common law, centre on the disclosure of information rather than merit regulation. The most relevant public policy arguments are noted in the discussion document.

4.1.3 It is highly unlikely that people with little knowledge of investment matters would trade futures on the NZFOE. Research and experience have consistently shown that restrictions on competition are detrimental to the interests of consumers. The government's oversight over the rules of the New Zealand Stock Exchange is an unnecessary restraint on the freedom of contract between members and their Exchange. It makes changes to the Exchange's rules slow and costly. One cost is the possibility that misplaced anti-market and populist sentiments may impede desirable amendments. Investors can trade unlisted securities, for instance units in unlisted unit trusts, or buy and sell securities listed on exchanges in other countries. There are no persuasive public policy grounds for regulating futures exchanges, the rules of the New Zealand Stock Exchange or any similar exchanges that may be established.

4.1.4 The discussion document notes that there are controls over the use of the term 'bank'. The question of whether entry into the banking industry or, more specifically, the settlements process should be

regulated is a wider issue than is recognised in the discussion document. We have argued for greater reliance on market-based supervision of registered banks and for other regulatory changes (see New Zealand Business Roundtable, 1993). If the government were to move in the direction that we have advocated, it may be possible to remove controls on the use of the term 'bank'.

4.2 Occupational regulation

4.2.1 The following occupations are subject to industry-specific regulation:

- Sharebrokers. No person may act as a sharebroker unless he or she holds a licence granted by a District Court judge.
- Futures dealers. No person may carry on the business of dealing in futures contracts unless he or she is a member of an authorised exchange or the person is authorised by the Commission to carry on the business of dealing in futures contracts. Although electricity futures are not traded on an authorised exchange, dealers in such futures and the operator of the exchange are authorised by the Commission.
- Statutory supervisors and trustees. Only persons approved by the Commission and trustee corporations can act as statutory supervisors under the Act. Similarly, every trustee of a unit trust must be a trustee corporation or a company or bank approved for the purpose by the minister.

4.2.2 These occupations are all licensed. While a persuasive argument needs to be advanced for any form of occupational regulation, a particularly compelling case is required to justify licensure because

it is the most restrictive form of occupational regulation.[6] In our submission to the Russell Committee we concluded that "it is difficult to identify any persuasive reason for sharebrokers to be licensed." We recommended that the Sharebrokers Act 1908 be repealed (New Zealand Business Roundtable, 1988). We believe this assessment remains valid today. The same conclusion applies to the licensing of dealers in futures.

4.2.3 The regulation of statutory supervisors and trustees requires somewhat closer examination. Sections 33(2) and (3) of the Act state that no debt or participatory securities may be issued to the public unless the issuer has appointed a person to act as a trustee or statutory supervisor respectively in relation to the security. A trustee for unit holders is required to be appointed by the Unit Trusts Act 1960. The role of a trustee or a statutory supervisor is to monitor whether the issuer meets its obligations. Trustees and statutory supervisors are intended to address an agency problem caused by a divergence between the interests of the issuer and investors. Their role is a regulatory response to a perceived public good problem as monitoring exhibits some features of a club service.

4.2.4 In the absence of regulation, issuers could arrange for the appointment of trustees to represent the interests of investors if the benefits outweighed the costs involved. Investors would choose to buy securities that offered this feature if they were prepared to bear the additional costs. There is no requirement to appoint trustees for bank depositors or investors in a life insurance policy, although it is apparent that the Commission would like trustees to be mandatory

[6] There are three forms of occupational regulation: licensure, certification and registration. With licensing a practitioner must obtain a licence from a regulatory agency to engage in the specified occupation or to carry out certain activities. Any person who does not hold a licence cannot lawfully engage in the occupation or undertake the activities specified. With certification a regulatory agency certifies that an individual has certain skills or expertise but cannot prevent the practice of any occupation by people who do not hold the relevant certificate. With registration people are required to be listed on an official register if they wish to engage in certain activities. There is no provision for denying the right to be registered or to engage in the activity, although a fee may be charged. Registration is often introduced to enable government policy to be applied. The registration of businesses for GST purposes and of motor vehicles to facilitate the enforcement of the road code are examples.

in the latter case. The appointment of trustees and statutory supervisors may discourage investors from monitoring issuers and may lead to a biased assessment of the risks involved. The discussion paper notes that some trustees have been negligent. While the divergence in interests between the issuer and investors may be reduced by the appointment of a trustee, a new agency problem is created as the interests of investors and their trustee are not necessarily the same.

4.2.5 While we are sceptical that a compelling case could be made for the mandatory appointment of trustees and statutory supervisors, they are an important feature of the present regime. Thus the question of whether the Commission should continue to authorise statutory supervisors and trustees should be considered in the context of the wider question of whether such agents should be required. Until this issue is resolved, the regulation of supervisors and trustees is unavoidable and the Commission is the appropriate body to authorise such statutory supervisors.

4.2.6 In the meantime a less restrictive form of occupational regulation, such as certification, should be considered. Any person (other than an undischarged bankrupt and people with convictions for dishonesty) could be permitted to be appointed as a trustee or statutory supervisor. However, people who meet set standards could be declared by the Commission to be certified to undertake the task. Any trustee or supervisor would be required to disclose whether he or she was certified. The criteria for the approval of certified or licensed statutory supervisors and trustees should be contained in the Act or regulations.

4.3 Exemptions from regulations

4.3.1 Section 5 of the Act empowers the Commission to exempt persons and classes of persons from compliance with certain provisions of the Act and related regulations. As noted in the discussion document, the authorisation of exemptions is a core activity of the Commission. The Commission argues that its exemption notices facilitate the development of new investment products under terms and conditions which enable securities laws to operate in a suitably straightforward manner and they address rigidities which from time to time affect more traditional products.

4.3.2 The Commission considered 85 exemption applications and issued 68 exemption notices during 1996/97. In June 1997 there were 80 exemption applications before the Commission, representing close to a year's work. The cumulative total of all exemptions approved by the Commission stood at 642 in June 1997. Of these 152 were in full force, 309 had been revoked, and some 181 appeared to have no further application. About 60 exemption notices were gazetted on 30 September 1997, the eve of the introduction of the changes arising from the investment product and adviser proposals. The Commission proposes to allocate 28 percent of its 1997/98 budget to the authorisation of exemptions. It has commenced a review of all exemption notices.

4.3.3 The relatively heavy reliance on exemptions provides *prima facie* evidence that the Act needs to be re-examined on a first principles basis. There is a cost in using authorisations to address shortcomings in the legislation. Aside from the direct expense involved, there is the cost of delay and a risk that unjustified restraints will be imposed. Furthermore, some issuers may choose to drop proposals rather than seek an exemption. Another concern is that the exemption process is not transparent. The disclosure of the terms and conditions of an exemption does not explain the reason for it and the principles that are to be applied in granting

exemptions are not specified. Better law could help in resolving these problems.

4.3.4 We agree with the view that existing law and regulations need to be applied with some flexibility. Most jurisdictions provide for the exercise of discretion in the application of their securities regulations. For this reason, the principle of issuing exemptions is endorsed. We think the process could be improved by prescribing the criteria for exemptions and notification of the reasons for exemptions in terms of those criteria. The question of whether the regulator should consult on exemptions should be left to its discretion. The maintenance of confidentiality may preclude consultation on occasions and some issues may not warrant consultations.

4.3.5 The Commission is the appropriate body to issue exemptions. We understand that the Commission is generally effective in undertaking this task. Franks (1996) notes that the Commission is prompt in matters which demand promptness, such as the processing of exemptions, and responsive to requests from issuers.

5 MONITORING AND INVESTIGATION

5.1 The Commission should restrict its monitoring and investigative activities to those securities matters for which it is directly responsible. Section 10 of the Act should reflect this approach. The criteria for initiating investigations should also be specified in the Act. These suggestions are consistent with our view that the Commission should have a minor role in law reform.

5.2 The Commission should monitor compliance with the law that it administers and undertake investigations into possible breaches of it that require action by the regulator. This role should not extend to breaches of private contracts, which are civil matters, or other breaches that can be privately enforced. The extent to which

taxpayer money is invested in such activities requires the benefits to be weighed against the costs involved. If private enforcement is facilitated, as proposed by the Roche committee, then lower investment in compliance monitoring than otherwise would be required by the Commission. Similarly, the higher the penalties for breaches, the less monitoring is required, other factors being equal, to discourage offences.

6 RELATIONS WITH GOVERNMENT AGENCIES

6.1 Section 6 of the discussion document seems to raise again elements of the Russell committee's proposal to establish self regulatory organisations (SROs) with statutory powers. The rules of SROs would be approved by a supervisory authority. This approach was rejected by the government and its implementation in the United Kingdom has come under question.

6.2 We agree with the Roche committee that the establishment of SROs with statutory powers is undesirable. A regulated system that is captured by producer interests may become a cartel which operates in the interests of established firms. With SROs such regulatory capture is present from the outset. Self regulation has been common in the professions – medicine, law and accountancy – and the outcome has been unjustified restrictions on entry into them, other anti-competitive practices such as controls on advertising and a slowness to innovate. Moreover, consumers have often had to overcome considerable obstacles to obtain redress for wrongdoing by members of these professions.

6.3 The government should justify any regulatory proposals against valid criteria and its regulatory regime should be transparent. It should not generally use the threat of formal regulation to force industry participants to act in manner that they may not otherwise choose. Nor should government agencies be concerned whether

the internal rules of organisations such as the New Zealand Stock Exchange are breached as that is a matter for their members.

6.4 The discussion paper's presumption that SROs have been established in New Zealand is worrying. The Commission is, in our view, stepping beyond the policy intent of the government and parliament if it is using the exemption regime to establish a *de facto* SRO regime as seems to be implied in paragraph 214 of the discussion document.

6.5 We see no reason for the Commission to exercise oversight over other government agencies. Clearly defined objectives, responsibilities and accountabilities are required for the effective management of government agencies. The Commission has a precise role as the regulator of securities markets. It should focus on its role. The regulatory role undertaken by the business and registries branch of the Ministry is equally clear. While there will always be some overlap between the responsibilities of government agencies (if there is more than one), that is not a sufficient reason to create a super agency. The responsibility of the Commission in respect of delinquent directors (discussed in paragraph 217 of the discussion document) should be reassigned to the business and registries branch of the Ministry as it is beyond the core role of the Commission. Any similar activities that should be the responsibility of that branch and *vice versa* should also be reassigned. Legislation could be required.

7 ENFORCEMENT

7.1 We agree with the Roche committee's argument that enforcement of securities and related law is a problem and with the thrust of the discussion in section 9 of its report. The Committee's recommendation that impediments to the private recovery of damages for breaches of the law should be addressed remains a priority.

8 EDUCATION AND PROMOTION

8.1 Regulatory agencies should make appropriate information available to people who are affected by their activities and to the public. The Commission should, for instance, publicise changes to the regime that it administers just as the Inland Revenue Department advises taxpayers of changes that affect them. It should also provide general information on the regime and its role, and respond to reasonable enquires about these matters as suggested by an affirmative response to the questions posed in paragraphs 307 and 309 of the discussion document. These activities should be motivated by the desire to facilitate voluntary compliance.

8.2 There are limits, however, to the Commission's education and information role. For example, we would not agree that the regulator's role is to *promote* New Zealand securities markets to New Zealand investors, let alone overseas investors, as raised in paragraphs 306 and 353. Such a role would raise moral hazard risks for taxpayers and conflict with the regulatory agency's key role. Similarly, the roles identified in paragraphs 308 and 310 are generally inappropriate for the Commission. Furthermore, it may be efficient to charge for the provision of certain information.

9 INTERNATIONAL LIAISON

9.1 The primary objective of the regulation of New Zealand securities markets should be to advance efficiency. New Zealand should not bow to pressure from other jurisdictions and adopt a regime that would not withstand scrutiny against that criterion. The decision, for example, to apply the Basle capital adequacy rules, which were inconsistent with New Zealand's policy on prudential supervision, was a mistake. Misguided and often self-serving criticism of our

regime by regulators and other officials from other countries ought to be vigorously countered.

9.2 Most international liaison on securities markets should be undertaken by the Ministry because the policy background is important. The Commission's role should be limited to questions of administration of New Zealand regulation and assistance, where appropriate, with investigations undertaken by counterpart agencies.

9.3 While cross-border issues may arise and relevant experience of other countries, particularly Australia, should inform policy formation in New Zealand, we do not envisage that international liaison should be a significant activity for either the Ministry or the Commission.

10 ACCOUNTABILITY

10.1 The discussion document reports that the Commission is subject to the standard accountability regime for Crown entities. The idea that it could be accountable to market participants is raised. That suggestion is mistaken. The Crown is the clear residual risk bearer. The suggestion reflects a stakeholder approach which is a recipe for conflicting objectives and confused accountability, and is inconsistent with the general approach applied to Crown entities and state-owned enterprises.

10.2 The performance of the Commission should be subject to closer monitoring by the government. Over recent years the Commission has promoted much low quality public policy advice that has been opposed by other government agencies and the private sector and rejected by the government. The Commission should not have been allowed to waste time and resources in this fashion. As suggested above, it should focus on its core regulatory role.

10.3 The Commission's performance standards for 1996/97 and 1997/98 are among the lowest quality standards of any government agency. This seems incongruous for an agency that enforces disclosure on participants in the securities markets and monitors non-compliance with accounting standards. It highlights the absence of appropriate monitoring of the Commission's performance.

10.4 The Commission's management practices should be modernised. The role of the Commission should be to appoint and monitor the chief executive, to set broad administrative policy and to bring experience and knowledge of the market to bear on the strategic work of the Commission. The day-to-day work of the Commission should be undertaken by the chief executive and his or her staff. This would require most powers of the Commission to be able to be delegated to the chief executive and then further delegated to appropriately qualified staff. As a general principle the Commission should be authorised to delegate its powers and it should decide which of them can be delegated to the chief executive.

11 FUNDING

11.1 The Commission expects an appropriation of $2.1 million (GST-exclusive) in 1997/98 and to receive fees and charges of $0.1 million. Expenditure on its main activities is projected to be as follows:

- $0.62 million for exemptions;
- $0.04 million for market authorisations;
- $0.77 million for market interventions;
- $0.6 million for law reform; and
- $0.18 million for public understanding.

The Commission expects to consider applications for 109 exemptions and 6 market authorisations, and to make 30 general market interventions and 40 relating to the banning of directors.

11.2 There have been claims that the Commission is inadequately funded. Taxpayers have, however, received poor value for money committed to policy development and law reform which accounts for 27 percent of the Commission's expected spending. In addition, some activities and occupations are unjustifiably subject to industry- or occupation-specific regulation. Thus spending on market authorisations, while not large, can be reduced by repealing the relevant sections of the Act. As noted above, the banning of delinquent directors should become the sole responsibility of the business and registries branch of the Ministry. The discussion document reports that Coopers and Lybrand believes that the Commission's costs can be reduced somewhat by delegating certain responsibilities to its staff, thereby reducing the need for formal meetings of the Commission. The Commission has authority to assent to a resolution without holding a meeting and this approach might be used where appropriate in the meantime.

11.3 It is also apparent that the design of regulatory interventions, in which the Commission has played a role, has created work for the Commission. The investment product and adviser disclosure proposals illustrate the problem. Rather than addressing clearly identified deficiencies in information disclosure (where justified), a broad-ranging regime was introduced. As a consequence, there are pressures to authorise exemptions. The Commission has belatedly moved to introduce class exemptions but the better course would be less and better designed regulation in the first place.

11.4 If the steps discussed above are implemented, the total spending of the Commission should be able to be reduced by at least 25 percent. Thus a total budget of not more than $1.6 million a year would seem to be sufficient.

11.5 The Commission should fully fund the services that it produces from user charges or use-related charges whenever this is efficient. Economic efficiency generally requires prices that reflect the marginal cost of producing a good or service. The Commission should not, however, use its regulatory powers to impose discriminatory charges or taxes.

11.6 User charges help to balance the cost of providing the service against the benefits that users derive. Where the purchase of a service is voluntary, the weighing up of costs and benefits generally leads to a better use of society's resources. In this situation under-pricing a good or service leads to its over-provision since the value derived by users from the excess production is likely to be less than its cost to society. Provisions which enable firms to opt out of a regulatory regime increase the potential efficiency gains from a user-pays structure.

11.7 User-pays arguments apply in respect of both public and private goods. Coopers and Lybrand are reported in the discussion document to have concluded that user charges should not be used to fund goods or services that exhibit strong public good characteristics. Although this view may be reasonable in some situations, in general there should be no such presumption. For some public goods, like lighthouses, direct user charges may not be feasible but proxies for use may provide an efficient substitute (eg fees for using port facilities). The charge applied to public issuers to fund the Accounting Standards Review Board is an example.

11.8 Where services are funded from taxes, consumer preferences must be expressed indirectly through the political process. Decisions on the appropriate quantity and quality of services must be made by politicians and administrators who cannot know what all individuals would prefer. Where goods or services are funded by taxes, there are strong incentives to lobby politicians and administrators for

favourable treatment. The administration and compliance costs incurred in collecting taxes are substantial. User charges for mandatory services are a form of taxation.

11.9 There are grounds for applying appropriate user charges for exemptions, authorisations and some education activities. Market intervention may be partly funded from fines and penalties (either directly or via an appropriation in lieu of fines paid to the Crown). The present level of fees for exemptions falls well short of the costs involved. Subject to detailed investigation, we think that about half of the Commission's costs should be able to be funded from user charges. (This assumes that law reform activities are reassigned as proposed.) Thus taxpayer-funding of the Commission could be reduced to $0.8 million.

12 CONCLUSION

12.1 The NZBR submits that:

- a larger efficiency gain can be obtained from a first principles review of the Securities Act 1978 and related regulations than from a review of the Securities Commission's role;
- the Securities Commission's core role should be to administer the regulation of securities markets. Its activities should be tightly focused on this role;
- the Commission should play a minor role only in policy development and law reform. It should advise on detailed legislative or regulatory matters relating to the administration of existing policy. The Commission should be consulted on the implementation and administration of new policy proposals;

- industry-specific regulation of futures exchanges, the New Zealand Stock Exchange, dealers in futures and sharebrokers should be abolished;

- the principle of issuing exemptions is endorsed. The existing process can be improved by prescribing the criteria for exemptions and notification of the reasons for exemptions in terms of those criteria. The Commission is the appropriate body to issue exemptions;

- the Commission should restrict its monitoring and investigative activities to the securities matters for which it is directly responsible;

- the Commission should not exercise oversight over other government agencies;

- the establishment of self regulatory organisations with statutory powers is opposed;

- the Commission should remain accountable to the Minister of Commerce and it should be better monitored;

- it should be possible to reduce the total spending of the Commission by at least 25 percent to not more than $1.6 million a year; and

- the Commission should fully fund the services that it produces from user charges or use-related charges where this is efficient.

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