

SHAREHOLDER DEMOCRACY OR SHAREHOLDER PLUTOCRACY? CORPORATE GOVERNANCE AND THE PLIGHT OF SMALL SHAREHOLDERS

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These scandals have hurt the reputations of many good and honest companies. They have hurt the stock market. And worst of all, they are hurting millions of people who depend on the integrity of businesses for their livelihood and their retirement, for their peace of mind and their financial well-being.

When abuses like this begin to surface in the corporate world, it is time to reaffirm the basic principles and rules that make capitalism work: truthful books and honest people, and well-enforced laws against fraud and corruption.¹

I INTRODUCTION

Corporate governance is an expression that was once confined in usage to a rather narrow group of academics, lawyers and boardroom participants. In recent years, however, the words have been the subject of extensive coverage in the financial pages of newspapers and electronic media. The recent corporate collapses of HIH, Harris Scarfe, Ansett and One.Tel in Australia, together with the collapse of Enron in the United States and revelations of accounting malpractice by WorldCom, Xerox and others have resulted in the issue of corporate governance becoming one of significant importance. The structures and laws by which corporations are governed — and in some cases misgoverned — are matters that have now moved into the public arena in a way that almost begins to approach the discourse on ‘civic governance’, that is, the government of the state.

The interest in corporate governance also arises from the increasing significance of corporations in daily life. The growth of corporations in the Western world and beyond since World War Two has been fuelled by both economic development and increased consumerism. In the late 20th century, the size and number of corporations was further spurred by the demise of command economies, financial deregulation, trade liberalisation, privatisation of

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1 George W Bush, ‘Remarks by the President on Corporate Responsibility’ (Speech delivered at the Regent Wall Street Hotel, New York, 9 July 2002), <<http://www.whitehouse.gov/news/releases/2002/07/20020709-4.html>> at 17 September 2002.

government business enterprises and the demutualisation of mutual societies. In addition, technology and the Internet continue to add to this growth.

The rise of corporate power has been apparent for some time. As early as 1932, Adolf Berle and Gardiner Means identified the potential of the modern corporation to ultimately rival the power of states:

The rise of the modern corporation has brought a concentration of economic power which can compete on equal terms with the modern state — economic power versus political power, each strong in its own field. The state seeks in some aspects to regulate the corporation, while the corporation, steadily becoming more powerful, makes every effort to avoid such regulation. Where its own interests are concerned, it even attempts to dominate the state. The future may see the economic organism, now typified by the corporation, not only on an equal plane with the state, but possibly even superseding it as the dominant form of social organisation. The law of corporations, accordingly, might well be considered as a potential constitutional law for the new economic state, while business practice is increasingly assuming the aspect of economic statesmanship.²

Increasing interest in corporate governance also arises from growing participation in corporations by small shareholders. In this article, I review some corporate governance issues relating to the 'small shareholder'. In doing so, I do not attempt to define that term with precision. It is used in a general sense to refer to shareholders with small holdings in large public corporations, and also to the particular type of small shareholder who is essentially a non-professional retail investor unable to closely monitor the market on an hourly (or even daily) basis. As will appear, this small investor is more than usually vulnerable to corporate misconduct, and reliant upon the observance of the law by corporations, their officers and larger players in the market.

Part II of the article describes the increasing numbers of small shareholders in recent years, and the factors contributing to this trend. Part III provides further background by reviewing the broad nature of corporate governance, comparing it to the government of society and highlighting the importance of information in the corporate polity. This theme is explored in the subsequent section, which outlines the legal framework affecting the information available to small shareholders, particularly the areas of insider trading, continuous disclosure and misleading and deceptive conduct. It is argued that the small shareholder is in a position of relative disadvantage, especially following the corporate law reform of the late 1990s. Finally, the article considers the remedies available to the small shareholder, and the possibilities these may provide in strengthening their position.

2 Adolf Berle and Gardiner Means, *The Modern Corporation and Private Property* (revised ed, 1967) 313.

II THE RISE OF THE SMALL SHAREHOLDER

Statistics showing a rise in share ownership in Australia have been well publicised. The most recent survey, conducted in November 2000,³ indicated that 2.1 million Australians had entered the share market directly or indirectly since 1998. The proportion of adult Australians involved in the market, either through direct shareholdings or indirectly via a managed fund was 52 per cent, with 40 per cent having direct holdings. Based on a population of 14.2 million adults, this equates to some 5.7 million people with direct share ownership and 7.4 million with direct and/or indirect share ownership.⁴

A number of developments have been critically important in this rise. Firstly, following the trend in the United Kingdom and other Western nations, most of Australia's larger insurance mutual societies have been demutualised and transformed into publicly listed corporations. Demutualisations in Australia have included National Mutual, Colonial Mutual, AMP and NRMA, the latter being the subject of significant litigation.⁵ Given the hugely dispersed ownership bases of mutuals, where the policy-holders own the organisation, their demutualisation, whereby ownership interests are turned into shares, has created huge numbers of new shareholders.⁶ Some former policy-holders have sold their shares, although the trend has been for investors to remain with companies. For example, 84 per cent of persons who received NRMA shares kept them.⁷

The second important development contributing to the increase in small shareholders has been the privatisation of former government businesses and statutory corporations. Many of these privatisations⁸ have focused on initial share offers that were promoted to attract individual investors as well as institutions. In this sense, both state and federal governments have been active in

3 See Australian Stock Exchange ('ASX'), *Australian Shareownership Survey* (2000), <www.asx.com.au/about/pdf/ShareownershipSurvey2000.pdf> at 17 September 2002; ASX, *Shareownership Update* (2000), <www.asx.com.au/about/pdf/Shareupdate150201.pdf> at 17 September 2002.

4 ASX, *Australian Shareownership Survey*, above n 3, 8.

5 One of the issues in the NRMA demutualisation was whether it was misleading to refer to members who surrendered their ownership rights as then receiving 'free shares': see *Fraser v NRMA Holdings Ltd* (1994) 52 FCR 1; *Fraser v NRMA Holdings Ltd* (1995) 55 FCR 452.

6 It is important to note that members have voted for demutualisation generally with the benefit of the recommendations of directors and detailed company reports which have set out the arguments in favour of — and also often against — demutualisation. Such arguments in favour have highlighted the greater benefits of shareholders' rights compared with policy-holders' membership rights. See, eg, AMP, *Proposal to Demutualise*, Explanatory Memorandum and Notice of General Meeting (1997).

7 ASX, *Shareownership Update*, above n 3, 8. Since that time, however, the NRMA (now the Insurance Australia Group) has reduced its share register from 1.7 million shareholders to 1.25 million through a A\$400 million share buy-back and on-market selling. In May 2002 it announced another A\$300 million buy back in an effort to reduce the dispersal of its ownership further: see Anthony Hughes, 'IAG Offers Second Share Buyback', *Business, The Age* (Melbourne), 28 May 2002, 2.

8 These include the Commonwealth Bank; Qantas Airways; Commonwealth Serum Laboratories; Telstra; state insurance corporations such as GIO; state banks such as the State Bank of South Australia; lotteries and gaming bodies such as Tabcorp; electricity commissions such as the State Electricity Commission of Victoria; and gas and other utilities.

enticing small shareholders into the market.⁹ This encouragement by the government needs to be borne in mind when the question of the adequacy of legislative protections for small shareholders is discussed.

A third development is the technological change leading to a substantially reduced cost of accessing the share market for small players.¹⁰ The development of low cost share trading using the Internet has led to substantially reduced transaction costs, making smaller trades more viable.¹¹ Information technology has also had the effect of lowering certain transaction costs of capital for public corporations. These include share registry costs and the costs of communication with shareholders — traditionally by post — in order to provide the annual report, dividend advice, notice of annual general meeting and, sometimes, shareholder news. These represent fixed costs per shareholder, which do not vary according to the size of the holding. Generally, these fixed costs equate to approximately A\$20 per year per shareholder.¹² The use of information technology by 'cyber shareholders' promises significant cost reductions in these areas.

A fourth concurrent development leading to a substantial increase in indirect participation in the share market has been the Australian government's institution of compulsory superannuation contributions. The compulsory employer contribution has risen steadily from an original 3 per cent of salary in the early 1990s to some 9 per cent of salary from 1 July 2002.¹³ This has created a massive pool of funds for investment, with total superannuation funds in Australia standing at A\$527.7 billion as at December 2001.¹⁴ A substantial proportion of these funds were invested in the Australian share market. Such funds represent beneficially the savings of hundreds of thousands of Australians, although institutional investors generally hold the shares. In this respect,

9 This process is continuing with the government's avowed desire to sell its remaining shareholding in Telstra. The Australian Labor Party has also floated a wider holding of shares by ordinary Australians as part of a broader public policy agenda of 'asset-based welfare'. See Mark Latham, 'Stakeholder Welfare' (Paper presented at the International Conference on Asset-Based Welfare, Institute for Public Policy Research and the Centre for Social Development, London, 11 January 2001).

10 See especially Elizabeth Boros, 'Corporations Online' (2001) 19 *Company and Securities Law Journal* 492. See generally 'Special Issue on Cybercorporation and Online Investing' (2001) 19 *Company and Securities Law Journal* 485–554.

11 A simple example would be a \$2000 trade. Not long ago it would have incurred costs from a stockbroker of approximately \$100 (5 per cent of the trade value). Today it can be traded on the Internet for less than \$20 (1 per cent of the trade value). Unless the dividend and capital gain potential were excellent, such trades would have previously been uncommercial. Today they are an economic proposition.

12 Ivor Ries, 'One Card Trick', *The Bulletin* (Sydney), 7 August 2001, 52.

13 See generally Malcolm Edey and Luke Gower, 'National Saving: Trends and Policy' in Reserve Bank of Australia, *The Australian Economy in the 1990s* (2000) 277, <<http://www.rba.gov.au/PublicationsAndResearch/Conferences/2000/>> at 27 September 2002.

14 Australian Prudential Regulation Authority ('APRA'), *Superannuation Trends* (2001), <<http://www.apra.gov.au/Statistics/Superannuation-Institutions-Statistics.cfm>> at 17 September 2002.

corporate governance concerns may transcend issues surrounding small shareholders.¹⁵

III THE CORPORATE POLITY — CORPORATE GOVERNANCE AND CIVIL GOVERNANCE

In analysing the position of the small shareholder, it is useful to review broadly the nature of corporate governance. In this regard, some interesting contrasts can be drawn between the government of corporations (corporate governance) and the government of society (civil or civic governance). These differences highlight the plight faced by the small shareholder.

Civil governance exists at varying levels from municipal to international forms, but achieves its most dominant form in the governments of nation states. There are observable parallels between the corporation and the state. For example, in the democratic state the members are citizens carrying the right to vote, whilst in the corporation the members are shareholders. Members elect directors to the board in the same way as voters elect representatives to Parliament. Some of these will operate in an executive capacity — executive directors will be analogous (at least in the Westminster system) to ministers of state. Completing the analogy will be management answerable to the board through the executive directors in the same way that civil or public servants are answerable to Parliament through ministers.

However, there are also a number of critically important distinctions between governance in the civic and the corporate sphere. Two of the fundamental principles of democratic civil governance are, firstly, that the voting franchise is extended to every adult member of the polity and secondly, that each vote is as near as possible to equal value. In the corporate realm, however, neither of these principles can be presumed. Not every stakeholder will be a member (shareholder), and of those who are members, there is no equality of voting power, as votes attach to shares rather than to shareholders. Another difference between civil and corporate governance relates to the mobile nature of the constituency in the corporate realm. These points of difference provide a starting point for understanding the plight of small shareholders in large corporations.

A Unequal Voting Power of Members

One factor that distinguishes the corporate from the civic polity is that members of the former do not have equal voting power. Voting rights are attached to shares rather than to individual shareholders. Different shareholders

15 For a discussion of the present and potential role of institutional shareholders in improving corporate governance in Australia see Ian Ramsay, Geof Stapledon and Kenneth Fong, 'Corporate Governance: The Perspective of Australian Institutional Shareholders' (2000) 18 *Companies and Securities Law Journal* 110.

hold vastly different numbers of shares and there is, therefore, no parity of voting power amongst shareholders.¹⁶

Thus, though the small shareholder will have a vote, their stake may be such that their vote is of significantly less value than that of a large shareholder. It will also be common that a few dozen large shareholders will, between them, have a majority that enables them to outvote tens of thousands of small shareholders. In this sense, corporations are more plutocratic than democratic. Voters in the civic realm who lament the ineffectiveness of their single vote to make a difference in the face of organised pressure groups in society should take comfort from their relative potency when compared with the small shareholder in a large corporate enterprise.

Whilst it appears elemental that the quantum of dividend rights should be linked directly to the quantum of a shareholding, it has been argued that it is not so axiomatic that voting rights should be so linked. Proponents of such arguments suggest that small shareholders should be given a greater say (with the corollary that the voting power of large shareholders should be capped).¹⁷ At the other end of the spectrum it has also been argued that corporations should be free to issue classes of shares that may have extra voting rights attached to them.¹⁸ The latter idea should be resisted as tending to expand the democratic deficit further (obviously depending upon the terms and conditions on which they are issued). Further, competition theory suggests that such 'super shares' may, depending again on their terms, have anti-competitive effects in the 'market for corporate control'¹⁹ by unfairly enhancing the market power of existing substantial shareholders.²⁰

B The Right to Convene a Meeting

An exception to the apparent tyranny of the large shareholders is s 249D(1)(b) of the *Corporations Act 2001* (Cth) ('*Corporations Act*'), which gives a right to 100 shareholders to compel the directors to call a general meeting. The section complements s 249D(1)(a), which entitles members with at least 5 per cent of 'the votes that may be cast at a general meeting' to compel directors to call a

16 Further, some corporations offer preference shares which generally carry no voting rights.

17 See David Ratner, 'The Government of Business Corporations: Critical Reflections on the Rule of "One Share, One Vote"' (1970) 56 *Cornell Law Review* 1.

18 See Saul Fridman, 'The News Corporation Super Shares Proposal: Crime of the Century or Tempest in a Teapot' (1994) 4 *Australian Journal of Corporate Law* 184.

19 Henry Manne, 'Mergers and the Market for Corporate Control' (1965) 73 *Journal of Political Economy* 110. See also Elaine Hutson 'The Market for Corporate Control in Australia' (1997) 16(2) *Economic Papers* 51.

20 Such 'super shares' will trade at a premium but because they maintain the same dividend entitlements, the premium will be significantly less than proportional to the increased voting rights (ie a share with five votes attached will not trade at five times the price of ordinary shares with one vote). In the 'market for corporate control' such shares would enable existing large shareholders to face a lower marginal cost to acquire control depending upon how close they already are to doing so. This appears to enhance their market power within that market.

general meeting.²¹ Section 249D(1)(b) is one of the few recognitions of shareholders as individuals in the *Corporations Act*. The importance of such provisions can be demonstrated by analysing the breakdown of the shareholdings of large Australian companies. Typically, large Australian public companies have a few dozen large institutional shareholders who hold the majority of capital, together with thousands of small shareholders who collectively hold only a small percentage of the capital.

By way of example, Fosters Group Ltd has an issued share capital of 2.011 billion shares and 169 768 individual shareholders. Of these, 146 533 have holdings of less than 5000 shares (of whom 56 290 have holdings of less than 1000 shares). Yet 66 per cent of the issued capital of the company was owned by just 20 large institutional shareholders.²²

Section 249D(1)(b) provides significant protection for the rights of small shareholders. However, it is currently under challenge. In 2000, the Companies and Securities Advisory Committee ('CASAC') recommended that the minimum 100 shareholder option under s 294D(1)(b) be abolished leaving only the minimum 5 per cent of voting capital requirement under s 249D(1)(a).²³ This recommendation was favoured by a number of large Australian public companies and their representative organisations.²⁴

The consequences of such a change would be severe. The number of small shareholders that would need to be amassed under the 5 per cent requirement is potentially vast. In the Fosters Group example, with over two billion shares issued, shareholders would need to hold a minimum of some 100 million shares to be entitled to requisition a general meeting. Thus, even if all 56 290 members who had holdings of less than 1 000 shares sought a general meeting, they would still not be able to meet the requirement. They could amass some 56 million shares at best, requiring a further 44 million. The requirement of 5 per cent is thus a substantial increase on the 100 shareholders required by s 249D(1)(b).

In its submission to the CASAC inquiry, the Australian Shareholders' Association supported continuation of the 100-shareholder test, though with a requirement that each shareholder hold a minimum marketable parcel of either A\$500 or A\$1000 in value.²⁵

21 The analogy with civil governance might suggest that shareholders are no more entitled to this right than are 5 per cent of voters to convene a sitting of Parliament. This criticism may not be apt because of the comparatively frequent sitting of Parliament. Certainly history is full of instances of struggles for self-determination, which is effected in practice through the creation of democratic legislatures which are expected to convene regularly. Further, where Parliaments have been shut down or prematurely dissolved the consequences have been severe. The failure of King Charles I to convene a Parliament from 1628 to 1640 was one of the main causes of the English Civil War and of the execution of the monarch: see generally George M Trevelyan, *A Shortened History Of England* (1942). In Australia, the Governor-General's dissolution of Parliament in 1975 precipitated a constitutional crisis: see, eg, Edward Gough Whitlam, *The Truth of the Matter* (1994).

22 Foster's Group Ltd, *achieving*, Concise Annual Report (2001) 51, <<http://www.fostersgroup.com/corporate/investor/reports/docs/annual2001.pdf>> at 17 September 2002.

23 Companies and Securities Advisory Committee ('CASAC'), *Shareholder Participation in the Modern Listed Public Company* (2000).

24 *Ibid* [2.15], [2.17].

25 *Ibid* [2.12].

The Commonwealth government accepted the recommendation of CASAC and sought to abolish the 100-shareholder test. However, this was defeated on 26 June 2000 when the Australian Labor Party and the Australian Democrats combined in the Senate to disallow the Corporations Amendment Regulation G.2.01.²⁶ Subsequently, on 18 December 2000,²⁷ the Minister for Financial Services and Regulation, Joe Hockey, proposed a compromise position: a test based on the numerical square root of the total number of members of a public company (ie, a company with 250 000 shareholders would have a threshold of 500 members). In response to criticism from the Australian Labor Party and others that this rule might in some cases lead to an unfairly high threshold, Mr Hockey in August 2001 floated the possibility that the square root equation might be subject to a cap of 500 members and a floor of 100.²⁸ The matter appears to have stalled for the moment. The new responsible minister, Senator Ian Campbell, has not indicated whether he proposes to continue with the square root rule.

C The Transient Constituency

A significant difference between civil and corporate governance is the transient or mobile nature of the members of the polity. The large scale trading of shares in public companies means that the corporation's constituency is constantly changing. Again, this is not a new phenomenon. In 1932, when establishing their argument as to the separation of ownership and control in the modern corporation, Berle and Means noted:

No one is a permanent owner. The composition of the thousandfold complex which functions as lord of the undertaking is in a state of flux ... This condition of things signifies that ownership has been depersonalised ... That depersonalisation of ownership simultaneously implies the objectification of the thing owned. The claims to ownership are sub-divided in such a fashion, and are so mobile, that the enterprise assumes an independent life, as if it belonged to no one.²⁹

This mobile constituency has various effects. One of these is the tendency to create a divergence between ownership and control.³⁰ Another significant result is the heightened importance of information. In the corporate polity, information is the common currency because it affects the collective valuation of the corporation's shares by the market, therefore affecting the entry and exit price of the polity. This affects the financial position of the members as they trade those shares. In broad terms, there is an obvious desire to exit relatively unsuccessful

26 See Commonwealth, *Parliamentary Debates*, Senate, 28 June 2000, 15892–15902.

27 See Joe Hockey, 'Vigilante Bands Should Lose Their Votes', *Australian Financial Review* (Sydney), 18 December 2000, 63.

28 Joe Hockey (Speech delivered to the Australian Shareholders' Association, Sydney, 16 August 2002).

29 Berle and Means, above n 2, 309. They quoted the view of Walter Rathenau concerning the then German version of the corporation.

30 This is a vast topic, with one of the more influential voices in recent years being Professor Mark Roe, who has analysed the historical, political and institutional reasons for the development of the American style of corporation as interpreted by Berle and Means with its comparatively widely dispersed ownership. See Mark Roe, *Strong Owners, Weak Managers: The Political Roots of American Corporate Finance* (1994); Mark Roe, *Political Preconditions to Separating Ownership from Control: The Incompatibility of the American Public Firm with Social Democracy* (1999).

corporations (characterised by falling share prices) and to enter successful corporations (characterised by rising share prices).³¹ In an analysis of the circumstances of the shareholder in the corporation, any inequality in information will immediately place that shareholder at a disadvantage. Avoiding an inequality of information is therefore one of the critical tasks of corporate governance and one of the persistent themes in corporate law and policy.

IV THE ARISTOCRACY OF INFORMATION

As argued above, information is the hard currency of the corporate realm. It is valued as objective data on the true state of corporations, which in the long run is reflected in their share prices. Importantly, however, information is also valuable because of its predictable short-term effects on the market when it becomes publicly known. The latter may involve a more tenuous connection with the objective facts of corporate wealth but allow windfall short-term gains.

The popular example is that of an oil company which has made a discovery of new oil reserves. Clearly those in possession of that information before it becomes publicly available are in a position to purchase shares on the market (usually from a person who is not aware of the information) at a price well below that which the market would otherwise place on those shares. When the information does become known, the share price will predictably rise and the insider, upon selling the shares, will make a gain. It makes no difference that the actual value of the oil discovery to the corporation may not be known for some time. The market will attribute a value to the discovery simply by virtue of the number of buyers who take the view that the discovery will be of value to the corporation and therefore purchase shares, thereby bidding up the share price.

The other example is the corporation that has been badly run and is about to announce a loss. A person who holds shares in the company and is aware of this information is in a position to sell those shares at a higher price (again generally to a person who does not have this information) than the market would otherwise value those shares if the information were publicly known. When the information does become publicly known the share price will fall and the insider will have avoided a loss.

Thus, it can be seen that inequality of information not only advantages the person who has the information but, as a general rule, disadvantages the person who does not have it. The assumption is that the person not in possession of the information would have acted differently if they were aware of the inside information. If a seller knew that they could shortly obtain a substantially higher price, they would refrain from selling at the lower price.³² As every transaction

31 This issue is echoed in civil governance with the natural desire of individuals to exit economically unsuccessful nation states and seek citizenship in more economically successful nations. The terms and conditions of such movements are also matters within the province of law which, in the early 21st century, are receiving considerable legislative and judicial attention.

32 There will of course be some exceptions to that general rule such as where a seller or sellers sold because they needed the cash immediately.

on the share market involves both a buyer and a seller, it is in this sense incorrect that insider trading is a victimless crime.

A Insider Trading

1 Policy and Theory

It has been argued that insider trading laws should be relaxed on the grounds that insider dealing can enhance market efficiency. By sending signals to the market, insider trading causes the price of securities to move towards their real value and creates a better informed, more efficient market that is less reliant on chance.³³ It has also been suggested that the rewards from such trading for insiders may be defensible as incentive-based forms of remuneration.³⁴

Market efficiency and fairness are generally acknowledged as the rationale behind securities market legislation.³⁵ In his judgment in *R v Firms*,³⁶ Mason P noted that the current Australian legislation arose out of a 1989 parliamentary committee report chaired by Alan Griffiths.³⁷ His Honour noted the theories that have been offered as a basis for prohibiting insider trading including:

- fairness, that is, market participants should have equal access to the relevant information from the company that issues the securities;
- fiduciary duty, that is, a person who holds a position of trust should not make a personal profit from that position without the informed consent of the beneficiaries;
- economic efficiency, that is, insider trading is damaging to the integrity of the financial market; and
- corporate injury, that is, insider trading injures the company which issued the securities, the shareholders in the company and investors who deal with insiders.³⁸

He concluded that 'the legislative history suggests that Parliament left the courts with a scheme embodying the ambiguous embrace of the market fairness/"equal access" and market efficiency theories'.³⁹

The efficiency argument for relaxing insider trading laws can only proceed on the basis that the fairness requirement is substantially or completely abandoned. The obvious question that flows from claims of a more efficient market is, for whom are they more efficient? Even assuming that there are true efficiencies generated by insider trading (that go beyond the gains for some players directly offset by the losses of other players), the other problem with the efficiency

33 See Henry Manne, 'In Defence of Insider Trading' (1966) 43 *Harvard Law Review* 113; Lori Semann, Mark Freeman and Michael Adams, 'Is Insider Trading a Necessary Evil for Efficient Markets? An International Comparative Analysis' (1999) 17 *Companies and Securities Law Journal* 220.

34 Dennis W Carlton and Daniel R Fischel, 'The Regulation of Insider Trading' (1983) 35 *Stanford Law Review* 857.

35 Semann, Freeman and Adams, above n 33, 221.

36 (2001) 51 NSWLR 548.

37 House of Representatives Standing Committee on Constitutional and Legal Affairs, Parliament of Australia, *Fair Shares for All: Insider Trading in Australia* (1989).

38 *R v Firms* (2001) 51 NSWLR 548, 556-7.

39 *R v Firms* (2001) 51 NSWLR 548, 557 (Mason P).

argument is that it appears to proceed on the basis that the efficiencies are ends in themselves without necessarily bothering to argue the case of how such efficiency may lead to overall public benefit in the corporate polity or beyond.

In this regard we come back to the problem of defining the polity. Actual buyers and sellers are certainly included, but what about potential buyers and sellers? How might these potential participants be identified? Other stakeholders (employees, customers and creditors) and the general public must be excluded on a pure market analysis, but in the larger view their position may be relevant. If a significant relaxation of insider trading laws created 'an incentive for corporate insiders to enter into risky or ill-advised ventures for short term personal gain',⁴⁰ this may ultimately lead to corporate failure with impacts on a wide spectrum of employees and customers and other stakeholders. Recent developments in the US raise concerns about share options creating incentives for measures that artificially increase the short-term share price. It is argued that the same problem, a fortiori, could clearly arise if a green light were given to insider trading.

Further, the argument that insider trading has benefits for all market participants in reducing the market's overall reliance on chance should more properly be directed towards support of stronger laws on disclosure, rather than weaker laws on insider trading.⁴¹

2 *Financial Services Reform and the New Insider Trading Provisions*

Insider trading has been proscribed under provisions in the national law since the *Securities Industry Act 1980* (Cth).⁴² The most recent provisions, effective from 11 March 2002, were introduced by the *Financial Services Reform Act 2001* (Cth). They changed the law in two main respects. Firstly, in accordance with the general direction of the reforms, the provisions have been widened to apply 'financial products' traded on a financial market generally.⁴³ Secondly, there has been a response to the perceived practical problems in proving insider trading offences. There have been relatively few prosecutions (six in the last ten years) with the first successful convictions both being overturned on appeal.⁴⁴ One reason for this low level of prosecution is the difficulty of detection. Another relates to evidentiary problems, particularly given the traditional criminal standard of proof required for prosecutions by the Australian Securities and Investments Commission ('ASIC')⁴⁵ and the requirement to prove that such

40 Thomas Newkirk and Melissa Robertson, 'Insider Trading: A US Perspective' (Paper presented at the International Symposium on Economic Crime, Cambridge, England, 19 September 1998).

41 See below Part IV(B) for a discussion of possible stronger disclosure laws.

42 As well as the earlier *Securities Industry Act 1970* (NSW).

43 'Financial products' now include securities (shares), derivatives, managed investment products, superannuation products (unless excluded by the regulations) and any other financial product which may be traded on a financial market generally: *Corporations Act 2001* (Cth), pt 7.10 div 3. The new provisions are effective from 11 March 2002.

44 See *R v Hannes* (2000) 158 FLR 359; *R v Firms* (2001) 51 NSWLR 548. Note that retrial of the former matter has recently again returned a guilty verdict: see, eg, Ashley Crossland, 'Hannes Guilty ... Again', *Australian Financial Review* (Sydney), 12 September 2002, 1. At the time of writing, sentencing had not been determined.

45 *Corporations Act 2001* (Cth) s 1308A.

information would have a 'material effect' on share price.⁴⁶ This difficulty of proof has led some commentators to suggest a reversal of the onus of proof once a *prima facie* case of insider trading has been established.⁴⁷

The new provisions do not extend this far, but they do provide some assistance to actions. The new s 1043A of the *Corporations Act* provides that insider trading will be both an offence and a civil penalty provision under s 1317E. Therefore, ASIC will in future have the option of choosing to take proceedings under which the civil rules of procedure and evidence — including the civil burden of proof — will be applied.⁴⁸

In civil actions, however, the position of defendants is assisted by the defence in s 1043L(7) where the 'inside' information came into their possession solely as a result of it being 'made known in a manner that would, or would be likely to, bring it to the attention of persons who commonly invest in Division 3 financial products of a kind whose price might be affected by the information'. This phrase forms part of the definition of when information is 'generally available' in s 1042C. Significantly, however, the reference omits the second part of that definition, s 1042C(b)(ii), which provides that since the information was made known 'a reasonable period for it to [have been] disseminated among such persons has elapsed'.⁴⁹

This defence allows for a person to be relieved partly or wholly from liability to pay compensation. It is a potentially wide exception and likely to be of considerable benefit to swift acting market investors who make it their business to have rapid access to, and act on, information that has been 'made known' in an open, though perhaps not universal, manner. It is argued that the omission of the requirement of a reasonable (or any) time for dissemination means that fast acting investors will be permitted to profit at the expense of investors who do not have immediate and rapid access to such information and who may inadvertently trade in ignorance of that information. It remains to be seen what practices courts will see as adequate means of bringing information to the attention of persons who commonly invest in securities.

B Continuous Disclosure

The type of insider trading that may face an actual prosecution will likely represent the sharper edge of the problem of inequality of information. At the softer edge, however, will be various issues arising from the approach of corporations to their disclosure requirements.

Section 674 of the *Corporations Act*⁵⁰ establishes continuous disclosure requirements for listed public companies by giving legislative force to the Australian Stock Exchange ('ASX') Listing Rules. Of particular relevance is Listing Rule 3.1 on continuous disclosure which provides that:

46 *Corporations Act 2001* (Cth) s 1042D.

47 See Roman Tomasic, *Casino Capitalism? Insider Trading in Australia* (1991).

48 *Corporations Act 2001* (Cth) s 1317L.

49 *Corporations Act 2001* (Cth) ss 1043L(7), 1042C(1)(b)(i).

50 The provisions were redrafted and relocated by the *Financial Services Reform Act 2001* (Cth). Prior to 11 March 2002 the relevant provisions were ss 1001A–1001D.

Once an entity is or becomes aware of any information concerning it that a reasonable person would expect to have a material effect on the price or value of the entity's securities, the entity must immediately tell ASX that information. This rule does not apply to particular information while each of the following applies:

3.1.1 A reasonable person would not expect the information to be disclosed.

3.1.2 The information is confidential.

3.1.3 One or more of the following applies:

- (a) It would be a breach of a law to disclose the information.
- (b) The information concerned an incomplete proposal or negotiation.
- (c) The information comprises matters of supposition or is insufficiently definite to warrant disclosure.
- (d) The information is generated for the internal management purposes of the entity.
- (e) The information is a trade secret.

Clearly, there are a number of significant exceptions carved out from the strong general rule. In relation to the meaning of 'confidential' in Listing Rule 3.1.2, ASX Guidance Note 8 states:

The second requirement of the exception is that the information is confidential. 'Confidential' in this context has the sense of 'secret'. It means that the information is in the possession of only those who would not be able to trade in the entity's securities and there is control over the use of the information. If the information is no longer confidential, Listing Rule 3.1.2 is no longer satisfied and the exception no longer applies. This is the case even if the entity has entered into confidentiality arrangements and/or the information has come from a source other than the entity.⁵¹

This does not provide much guidance on what can properly be kept secret from the shareholders and the market. It is a concern that has been voiced by members of the corporate community. At a forum on corporate disclosure in April 2002, Takeovers Panel member and company secretary of BHP Billiton, Karen Wood stated that the exemption clause in Listing Rule 3.1 was unclear and that further guidance was needed.⁵²

Confidentiality is a potentially meaningless concept if not limited by reference to confidentiality in the interests of the corporation and its shareholders. Protection of trade secrets and intellectual property and information that might benefit competitors, customers or suppliers to the detriment of the corporation is undoubtedly a legitimate interest. On the other hand, it is not difficult to envisage a situation where confidentiality may benefit management while providing doubtful benefit to the corporation or its shareholders, such as where management attempts to suppress evidence of its own incompetent or wrongful acts.

The meaning of the confidentiality requirement may be clarified under current ASX proposals to enhance the continuous disclosure regime.⁵³ These propose to modify the relevant limb of the carve out to require that the information be confidential, and that the ASX be satisfied that confidentiality has in fact been

51 ASX, Guidance Note 8, *Continuous Disclosure: Listing Rule 3.1* (2002).

52 Jan Eakin, 'Executives Upset Over Fuzzy Rule 3.1', *Business, The Age* (Melbourne), 10 April 2002, 5.

53 ASX, Exposure Draft, *Proposed ASX Listing Rule Amendments Enhanced Disclosure* (2002), <<http://www.asx.com.au/about/pdf/ExposureDraftJuly2002EnhancedDisclosure.pdf>> at 1 October 2002.

maintained. It also proposes that notes be inserted in the rule that describe the circumstances in which the ASX will not be satisfied in this regard.⁵⁴

An aspect of disclosure that has been publicly questioned in recent times is the practice of some corporations in providing selective briefings 'behind closed doors' to certain fund managers and shareholders. In the absence of explanation, this conduct by definition amounts to a *prima facie* case of unequal disclosure. Such selective disclosure acts to the detriment of the small non-institutional shareholders who are not involved. The corporations in question claim that everything disclosed is publicly available, but critics respond that this makes it difficult to see what purpose the briefings actually serve.⁵⁵

Another contentious area in relation to disclosure is the adequacy of corporate responses to ASX queries in situations where share price movements are clearly taking place. In some cases, this can raise a question as to whether persons with higher quality knowledge or even inside knowledge are trading. In many cases those trading will have no inside knowledge and will only be responding to rumour. In both cases, however, an onus arises for corporations to provide adequate information to prevent trading where there is either an absence of relevant information or an inequality of information.⁵⁶

Market and investor sentiment may ultimately be more effective than 'boiler plate' disclosure rules in ensuring companies provide high quality disclosure to investors.⁵⁷ On this view, it is suggested that the market will price such company shares at a discount because of poor disclosure practices. However, in some cases the poor disclosure will not be immediately apparent, emerging only at a later time. The market-based solution therefore, will provide no later comfort to the investors who have already lost through decisions made on the basis of poor or inadequate disclosure.

In September 2002, Federal Treasurer Peter Costello released a paper containing 41 proposals on corporate disclosure, forming the basis of a ninth

54 Ibid 45 ff.

55 A recent well-publicised case saw ASIC investigating AMP in relation to selective briefings. The latter denied that any unfair advantage was given, though it accepted that such a perception could have been created. It subsequently conducted an internal review resulting in an expansion of its disclosure policies and practices: See Australian Securities and Investment Commission, 'ASIC Commences Investigation into Disclosure by AMP Limited' (Press Release 01/285, 14 August 2001), <<http://www.asic.gov.au>> at 17 September 2002; AMP Ltd, 'AMP Strengthens Approach to Disclosure' (Company Announcement to the Australian Stock Exchange, 23 August 2001); AMP Ltd, 'Review of Disclosure Policies & Practices' (Company Announcement to the Australian Stock Exchange, 30 July 2001).

56 A recent example of a response to an ASX query where share price movements were taking place was in relation to Western Mining Corporation ('WMC') shares on 12 October 2001 where no announcement to the ASX had been made. An announcement was later made on 17 October 2001 that WMC was in discussion with various parties about a takeover or reconstruction: WMC Ltd, 'Company in Discussions' (Company Announcement to the Australian Stock Exchange, 17 October 2001). ASIC noted that it had been advised by senior counsel that although there was a good arguable case that WMC breached ASX continuous disclosure rules in the period prior to 17 October 2001, there was considerable doubt that any effective remedy was available to ASIC under the Corporations Act: ASIC, 'ASIC Concludes Investigation into WMC Ltd' (Press Release 02/79, 7 March 2002), <<http://www.asic.gov.au>> at 17 September 2002.

57 Tom Ravlic, 'Market Will Ensure Companies Toe Line', *Business, The Age* (Melbourne), 21 January 2002, 2.

tranche of the Corporate Law Economic Reform Program ('CLERP 9').⁵⁸ The proposals include significantly higher civil penalties and power conferred on ASIC to issue financial penalties administratively for non-disclosure. Proposal 27 states that market operators (such as the ASX) should require listed entities to respond to externally generated speculation where the operator determines that this is having a significant impact on the market for their securities.⁵⁹ There is, however, no suggested legislative response or any additional role for ASIC. The recommendation does not appear to go further than what ASX might already be legitimately expected to do.

The CLERP 9 recommendations also suggest legislating for qualified privilege and protection against retaliation in employment for company employees reporting a suspected breach of the law to ASIC.⁶⁰ In addition, civil recovery provisions relating to contraventions of the continuous disclosure provisions are to be amended to clarify that a person may seek compensation from the company or other persons involved in the contravention, regardless of whether ASIC has sought a declaration of contravention.⁶¹ In practice, the apparent enhancement of shareholder rights inherent in the latter proposal may be thwarted by the fact that the privilege in the former proposal is not proposed to extend to employee witnesses reporting such matters to persons seeking such compensation and their legal representatives. Thus, where ASIC declines to take action there may be significant practical problems of proof for persons seeking to take private proceedings.

C Misleading Conduct and Small Shareholders

Related to the issue of non-disclosure, though often more severe in nature, is the area of misleading and deceptive information being provided by corporations to their shareholders. Section 1041H of the *Corporations Act* is now the 'misleading and deceptive conduct' provision applying to most share market activity. It has its provenance in s 52 of the *Trade Practices Act 1974* (Cth). At the time it was introduced into the *Corporations Act* the explanatory memorandum stated that:

The clause emphasises that persons, in their dealings in the securities industry, should not engage in misleading or deceptive conduct ... A guide to what type of conduct is misleading or deceptive can be gained from the many cases decided under Section 52 of the *Trade Practices Act*.⁶²

Other legislation dealing with misleading and deceptive conduct has gradually been pared back. Since 1998, s 52 of the *Trade Practices Act 1974* (Cth) no longer applies to financial services which includes 'providing a security or a

58 Department of the Treasury, *Corporate Disclosure: Strengthening the Financial Reporting Framework* (2002) ('CLERP 9'), <<http://www.treasury.gov.au/contentitem.asp?pageId=035&ContentID=403>> at 30 September 2002.

59 Ibid 157.

60 Ibid 179, Proposal 35.

61 Ibid 156, Proposal 24.

62 See Explanatory Memorandum, *Corporations Bill 1988* (Cth).

service in relation to a security'.⁶³ Further, since 13 March 2000, s 12DA of the *Australian Securities and Investment Commission Act 2001* (Cth) has been amended by the *Corporate Law Economic Reform Program Act 1999* (Cth) ('the CLERP reforms') so that it does not apply to 'dealings in securities'.

The *Company Law Review Act 1998* (Cth) and the CLERP reforms have also changed the pure 'misleading and deceptive conduct' claim in relation to misleading or deceptive statements in prospectuses and takeover documents. Misleading or deceptive statements in relation to a takeover or a compulsory acquisition document are now governed by s 670A of the *Corporations Act*, with the right to recover losses outlined in s 670B. Misleading or deceptive statements in a fundraising disclosure document fall under s 728 of *Corporations Act*, and the right to recover loss or damage is set out in s 729.

Prima facie, the consequences of breaching ss 670A or 728 appear to be more severe, as they now carry criminal, as well as civil, consequences. In reality, however, these consequences are substantially mitigated by the statutory defences now available.⁶⁴ Neither s 1041H nor any of the old misleading and deceptive conduct legislation provided these defences. Under the old s 52, there was no requirement to show knowledge of the misleading or deceptive nature of a takeover or disclosure document,⁶⁵ but the new defences (particularly under ss 670D and 732) bring a knowledge requirement through the 'back door' (albeit with a reversed onus of proof), by providing a defence where a person can prove that they did not know the material was misleading or deceptive.

Misleading information or failure to disclose important relevant information is an issue for all shareholders, not just small shareholders. Nevertheless, misleading conduct by corporations is of specific concern to small shareholders because of the practicalities of market operation. Many of these small shareholders are part-time, non-professional investors, with typically neither the time nor the ability to closely monitor market developments. In the case of misleading information, the 'aristocracy of information' operates in the market not in an absolute but rather, in a relative sense.

The professional and institutional investor, through relatively greater access to research, information and expertise is in a better position to be sceptical of claims made by corporations and may be able to identify misleading claims sooner. The inaccuracy of profit forecasts and sales figures, or yearly accounts that do not have a reasonable basis in fact, will usually tend to become more apparent to the market over time. In this regard, the aristocracy of information operates with informed professional investors and institutional investors becoming aware of potential inaccuracies through their own critical analysis, well before smaller and less informed investors in the market. This allows professional investors and institutions to dispose of those shares at a better price

63 See *Trade Practices Act 1974* (Cth) s 51AF. In relation to the definition of 'financial services' see *Trade Practices Act 1974* (Cth) s 4(1); *Australian Securities and Investments Commission Act 2001* (Cth) s 12BA.

64 See *Corporations Act 2001* (Cth) ss 670D, 731, 732, 733.

65 Though in relation to predictions that do not materialise, having reasonable grounds for those predictions has always been a defence. See, eg, *Trade Practices Act 1974* (Cth) s 51A.

than would otherwise be the case. This is not insider trading, nor is it illegal. On one view, it is simply the reward for prudent monitoring of the market and intelligent, realistic scepticism. Nevertheless, it is undoubtedly to the relative benefit of the large investor and the relative detriment of the small. Given that the source of the original problem is wrongful conduct — the making of misleading and deceptive statements — it is a form of operation of the market that cannot be condoned.

The other related situation of relative disadvantage in a case of misleading conduct by corporations occurs when correcting material is released to the market. Even though there may be no inside knowledge that such material is about to be disclosed, undoubtedly those who are closely monitoring the market will have the first opportunity to act quickly. They will be able to exit a corporation that is experiencing a financial downturn or buy shares in a corporation that announces a better than expected result.

V THE 1998 CLERP REFORMS — EROSION OF THE POSITION OF THE SMALL SHAREHOLDER?

A Compulsory Acquisition

Vanessa Mitchell has cogently argued that the CLERP reforms of the late 1990s, effective since 1 July 1998,⁶⁶ have introduced changes which have weakened the powers of minority shareholders whilst strengthening those of the majority.⁶⁷ These amendments included enhancement of the compulsory acquisition power through the effective reversal of the decision of the High Court in *Gambotto v WCP Ltd*.⁶⁸ The requirements of the High Court in that decision — that there be a ‘proper purpose’, ‘fair dealing’ and the payment of a ‘fair price’ — have been largely replaced by the role of the ‘independent expert’ nominated by ASIC, who is required to state that the acquisition is for fair value. If the matter is ultimately referred to a court, the court is constrained to review the fair value aspect of the transaction but not the fair dealing aspect and the notions of procedural fairness involved in the latter.

Mitchell notes that:

There are undoubtedly many advantages to a company in eliminating minority shareholders and achieving 100 per cent ownership in one shareholder. These include tax advantages and simplified administration and reporting procedures.⁶⁹

She notes the decision of Douglas J in the Supreme Court of Queensland in *Pauls Ltd v Dwyer*⁷⁰ on the new provisions which has confirmed that fair value will not include a premium for the special value of the outstanding securities to the acquirer. Since that time, Warren J in the Supreme Court of Victoria in

66 *Corporate Law Economic Reform Program Act 1999* (Cth).

67 Vanessa Mitchell, ‘Has the Tyranny of the Majority Become Further Entrenched?’ (2002) 20 *Company and Securities Law Journal* 74.

68 (1995) 182 CLR 432.

69 Mitchell, above n 67, 75.

70 (2001) 19 ACLC 959.

*Capricorn Diamonds Investments Pty Ltd v Catto*⁷¹ has also confirmed that any special value that an acquirer derives from 100 per cent ownership is to be disregarded when determining fair value.⁷²

Mitchell also notes the importance of the 'independent expert' under the new regime and questions the decision of Douglas J in *Pauls Ltd v Dwyer*⁷³ to allow the same expert to determine the offer price in the interests of the 90 per cent majority shareholder (Pauls Ltd), and then 'change hats' to report on whether the offer was fair to the minority.⁷⁴

In so far as the valuer's expertise now supplants some of the discretion that courts may once have exercised, the independence of that expert becomes a primary consideration. This might at first glance appear to be unproblematic given that the expert will be nominated by ASIC (pursuant to s 667AA(2)). Section 667AA(2)(b), however, provides that ASIC may alternately nominate 'up to 5 appropriate persons one of whom the person making the request may choose to prepare the report'.

This section clearly opens up the possibility of 'expert shopping' and potentially erodes the independence of such experts and the protection they afford minority shareholders. CASAC makes surprisingly short mention of the expert's role in their original report.⁷⁵ In its 1999 report in response to submissions by the Australian Shareholders' Association, CASAC noted only

that the CLERP Bill would require the disclosure of any prior dealings or relationships between the expert and the 90% holder. In addition, a court could assess any concerns about whether an expert's report properly assessed fair value in determining whether to approve the compulsory acquisition. The Committee considers that these controls are adequate and satisfactory in this context.⁷⁶

B Capital Reduction

The rights of minority shareholders in a selective capital reduction have been diminished as a result of the CLERP reforms relating to capital reductions.⁷⁷ The new rules remove the automatic requirement that the court actively confirm the decision to reduce capital.⁷⁸ Without this automatic right of review, concerned shareholders are faced with the difficulty and expense of initiating a court action in order to have the validity of a selective capital reduction examined. This action will normally be an injunction to restrain the reduction under s 1324 of the *Corporations Act*.⁷⁹

71 (2002) 41 ACSR 376.

72 See also *Kelly-Springfield Australia Pty Ltd v Green* (2002) 20 ACLC 983 (Santow J).

73 (2001) 19 ACLC 959.

74 See also Katherine Morgan-Wicks 'The New General Compulsory Acquisition Power: Re-establishing the Minority's Right to an Independent Expert' (2001) 19 *Company and Securities Law Journal* 349.

75 Companies and Securities Advisory Committee, *Compulsory Acquisitions* (1996).

76 Companies and Securities Advisory Committee, *Compulsory Acquisitions and Buy-Outs* (1999).

77 Mitchell, above n 67, 77.

78 *Corporations Act 2001* (Cth) pt 2J.1.

79 It should be noted that the court's automatic involvement under the old law did not mean that minority opposition would not be overridden if the price was fair: *Nicron Resources Ltd v Catto* (1992) 8 ACSR 219.

VI FINANCIAL REPORTING AND THE IMPORTANT ROLE OF AUDITORS

Although inadequate financial reporting and poor audit quality hurts all shareholders, smaller retail shareholders are often slower to react when it becomes apparent. As stated above, they may be slower to react to the realisation that they have been misled. As a result of this failure to take swift action to minimise their losses, smaller retail shareholders are likely to suffer relatively more.

Professor Ian Ramsay noted in his recent report on the independence of company auditors,⁸⁰ that audits:

- (a) add value to financial statements by improving their reliability;
- (b) add value to the capital markets by enhancing the credibility of financial statements;
- (c) enhance the effectiveness of the capital markets in allocating valuable resources by improving the decisions of users of financial statements; [and]
- (d) assist to lower the cost of capital to those audited financial statements by reducing information risk.⁸¹

Thus, the auditor's role includes an obligation to provide accurate accounts to both the shareholders and to the capital markets generally. That is, their obligation extends to former, current and potential shareholders as well as non-equity financiers. The audit is financed by the shareholders, justifying a special obligation to this group (including the small shareholders). However, because of the broad obligation to the markets generally, the role of auditors is more akin to a regulatory role than a service role.

On incorporation of a company, auditors are initially appointed by the directors, with the members at the first annual general meeting officially appointing auditors who will hold office until death, removal or resignation.⁸² In the case of small shareholders, without highly effective organisation and alliance with large institutional shareholders, they are unlikely to be able to exert any significant role in relation to either the appointment or removal of auditors. The Ramsay report suggests establishing audit committees which in turn will recommend on the appointment and remuneration of auditors.⁸³ Such a change would enhance the authority of audit committees. However, there is no suggestion (either in the Ramsay report or in the CLERP 9 proposals)⁸⁴ of a requirement of representation of small shareholders on the audit committee.

80 Ian Ramsay, *Independence of Australian Company Auditors: Review of Current Australian Requirements and Proposals for Reform — Report to the Minister for Financial Services and Regulation* (2001) ('Ramsay report'), <<http://www.treasury.gov.au/contentlist.asp?classification=14&titl=Publications>> at 23 July 2002.

81 *Ibid* 18, paraphrasing the Independent Standards Board, Discussion Memorandum, *A Conceptual Framework for Auditor Independence* (2000).

82 *Corporations Act 2001* (Cth) s 327.

83 Ramsay, above n 80, 14.

84 CLERP 9, above n 58.

I have suggested that the auditor's role is closer to a regulatory role than a service function. On this view, it is dangerous to consider a situation of easy appointment and removal of auditors as beneficial to small shareholders on the basis of competition theory (ie, where auditors compete to provide services to the customer with the latter being easily able to change if dissatisfied with the service). Such a competitive market theory approach is flawed due to the 'regulatory' nature of the auditor's role and conceptual problems in identifying the true 'consumer' of the audit service.⁸⁵ The likelihood that management (the regulated party) may influence auditor appointment also highlights the weakness in this approach.⁸⁶ Regulated mandatory rotation will thus be justified not by competition theory but on the rationale of encouraging independence by avoiding the regulatory capture⁸⁷ which can otherwise occur through the development of close or comfortable relationships between the regulator and the regulated.

The Ramsay report recommended mandatory rotation of audit partners after a maximum of seven years.⁸⁸ The government has accepted the recommendation and set its own preferred limit at five years.⁸⁹ However, the real solution is the mandated rotation of audit *firms* every five years. Anecdotal evidence suggests that most of the actual auditing function is performed by teams of employees answering to the audit partner rather than by the audit partner himself. In that situation, unless the entire team is changed, rotation of the audit partner may not have the desired effect of ensuring fresh personnel enter the auditing process.⁹⁰

The question of audit firms providing non-audit services was also explored in the Ramsay report, which outlined various recommendations pertaining to better disclosure of fees and the establishment of an Auditor Independence Supervisory Board.⁹¹ The government has recommended disclosure in annual reports of fees for non-audit work and a statement by the audit committee attesting to the absence of any conflict.⁹² These recommendations, however, fall short of the US approach of legislatively proscribing certain types of non-audit work.⁹³ Both small and large shareholders are entitled to insist that the audits that they ultimately pay for are both independent and seen to be independent. The reliance by large accounting firms on substantial non-audit income from companies they

85 This point is partially acknowledged in CLERP 9, above n 58, 38, though it is asserted (without proper explanation) that some level of competition on audit quality still operates through audit firm reputation.

86 In that regard, attempts to reform the role of state Auditors-General based on the National Competition Principles in the late 1990s were conceptually flawed.

87 See Toni Makkai and John Braithwaite, 'In and Out of the Revolving Door: Making Sense of Regulatory Capture' (1995) 1 *Journal of Public Policy* 61 in Robert Baldwin, Colin Scott and Christopher Hood (eds), *A Reader on Regulation* (1998) 173.

88 Ramsay, above n 80, 14.

89 CLERP 9, above n 58, 83, Proposal 9.

90 Given the questionable application of competition theory to the process, a tendering process would not be necessary for such rotation. Rather, ASIC could establish and maintain an appropriate panel of qualified audit firms appointing appropriate firms on a sequential basis.

91 Ramsay, above n 80, 9.

92 CLERP 9, above n 58, 69, Proposal 7.

93 *Sarbanes-Oxley Act of 2002*, Pub L No 107-204, § 201, 116 Stat 745 (2002). See also Tom Ravlic, 'Regulator Slams "Soft" Audit Reforms', *Business, The Age* (Melbourne), 23 September 2002, 1.

are auditing undoubtedly creates (at the least) the perception of a lack of independence.⁹⁴

VII REMEDIES FOR THE SMALL SHAREHOLDER

In the discussion so far, I have focused on the legal framework protecting shareholders and the way that small, non-professional shareholders can be at a disadvantage in the share market. I now consider some of the mechanisms available to overcome these disadvantages. In the corporate realm (as in commercial life generally) desirable economic and social behaviour occurs through a combination of enlightened self-interest amongst players together with economic or market penalties for inappropriate behaviour. Essentially, people may refuse to do business with those they do not trust. In addition there is a system of rules designed to encourage and facilitate beneficial corporate behaviour, the breach of which may entail civil or criminal penalties or both.

A Criminal and Civil Enforcement

Criminally wrongful behaviour is traditionally prosecuted by the state through its corporate regulator while civilly wrongful behaviour exposes the perpetrator to liability to a private individual or individuals, usually in the form of monetary damages.⁹⁵

Small investors often lack the resources to take private legal action for wrongful conduct and are thus particularly reliant on effective enforcement by the regulator. Such regulatory enforcement will tend to achieve some of the traditional purposes of the criminal law such as deterrence, punishment and reduction of such conduct through deprivation of normal freedoms (for example the freedom to be a company director).⁹⁶

In relation to the civil law, ASIC also has the power to seek civil recovery of property or damages for misconduct, such as fraud, negligence, default or breach of duty, in connection with a matter it has investigated where it appears to ASIC

94 Non-audit services (unlike the audit function) could then be competitively marketed and tendered for rather than relying on the audit role as a 'foot in the door'. Competition theory suggests that corporations would then benefit from price competition in relation to such services. For a short summary of the theory see Trade Practices Commission, *Submission to the National Competition Policy Review* (1993) Appendix B.

95 This model has been complicated by the fact that the corporate regulator, ASIC, has recently shown a tendency to rely on civil penalties rather than traditional criminal penalties. There are various reasons for this, including a generally lower standard of proof required in civil cases and a view about the nature of some breaches of the corporations legislation and the appropriateness of attaching the moral opprobrium of criminality. See Senate Standing Committee on Legal and Constitutional Affairs, Parliament of Australia, *Company Directors' Duties: Report on the Social and Fiduciary Duties and Obligations of Company Directors* (1989).

96 For a discussion of the traditional purposes of the criminal law, see James W Harris, *Legal Philosophies* (1980) ch 5.

to be in the public interest to do so.⁹⁷ ASIC's role is limited, however, by the resources at its disposal which means that it cannot investigate all matters reported to it or pursue all claims arising from those matters.

The function of the civil law in achieving restitution or compensation for the victims of misconduct is doubly important in relation to corporate misconduct because the nature of most corporate misconduct tends to manifest itself in an adverse financial impact on the victims of that conduct. Further, compensation also serves an important purpose of the criminal law by deterring such conduct by the offender in the future (though possession of insurance by the offending party will mitigate this effect slightly). The award of exemplary damages may also deter others from engaging in misconduct if the proceedings are well publicised.⁹⁸

Given the high utility of compensation to private victims of misconduct and the incidental effects of deterrence and punishment and the significant constraints on ASIC referred to above,⁹⁹ there is clearly a significant role for private enforcement and the seeking of private remedies where there has been corporate misconduct.

B Private Civil Enforcement and Remedies

1 The Statutory Derivative Action

A substantial change introduced by the CLERP reforms¹⁰⁰ was the introduction of a statutory derivative action, effective from 13 March 2000. The traditional common law derivative action derived from the fact that some misconduct was properly actionable by the company as a legal person rather than by its shareholders.¹⁰¹ In terms of our earlier comparison between the corporation and the state, a rough analogy may be the delegation of power by citizens to the executive government to prosecute some unlawful activity which offends the state, rather than all misconduct being the subject of private suits by citizens.

Under pt 2F.1A of the *Corporations Act*, a current or past member or officer may bring or intervene in proceedings on behalf of a company for the purpose of taking responsibility on behalf of the company for those proceedings, or for a particular step in those proceedings if that person obtains leave from the court. Section 237(2) provides that the court must grant the application if it is satisfied that:

- (a) it is probable that the company will not itself bring the proceedings, or properly take responsibility for them, or for the steps in them; and
- (b) the applicant is acting in good faith; and
- (c) it is in the best interests of the company that the applicant be granted leave; and

97 *Australian Securities and Investments Commission Act 2001* (Cth) s 50. As to evaluating what is the public interest see *Australian Securities Commission v Deloitte Touche Tohmatsu* (1996) 70 FCR 93.

98 Note, however, that Australian courts have been generally reluctant to order punitive damages.

99 See also ASIC, Policy Statement 4, *Intervention* (1991).

100 See above Part V.

101 *Foss v Harbottle* (1843) 2 Hare 461; 67 ER 189.

- (d) if the applicant is applying for leave to bring proceedings—there is a serious question to be tried; and
- (e) either:
 - (i) at least 14 days before making the application, the applicant gave written notice to the company of the intention to apply for leave and of the reasons for applying; or
 - (ii) it is appropriate to grant leave even though subparagraph (i) is not satisfied.

In *Chapman v E-Sport Club Worldwide Ltd*,¹⁰² Mandie J stated that the court must grant the application if satisfied of the above matters, but noted that the section does not say whether the court has a discretion to grant leave even if not satisfied of those matters. He ultimately found it unnecessary to decide the question but said:

when one looks at the matters of which a court must be satisfied before it is obliged to grant leave, it is hard to imagine how a court would, in most circumstances, grant leave unless those matters were made out, because if a court was not satisfied — for example, that the applicant was acting in good faith, or was not satisfied that the application was in the best interests of the company or was not satisfied that there was a serious question to be tried — it is hard to imagine how the court would have a residual discretion to grant leave.¹⁰³

Section 237(3) provides a rebuttable presumption that granting leave is not in the best interests of the company if it is established that the proceedings are by the company against a third party or by a third party against the company, and the company has decided not to bring the proceedings or not to defend the proceedings or to discontinue, settle or compromise the proceedings. The latter is subject to the proviso that all of the directors who participated in the decision must have acted in good faith for a proper purpose without a material personal interest in the decision, and must have informed themselves about the subject matter of the decision to the extent that they reasonably believed to be appropriate, and that they rationally believed that the decision was in the best interests of the company. The director's belief that the decision was in the best interests of the company will be considered a rational one unless the belief is one that no reasonable person in their position would hold.

Mitchell argues that it is unlikely that a minority shareholder would find the procedure easy to use or worthwhile, particularly given such a person's probable lack of inside knowledge regarding the company's affairs.¹⁰⁴ By contrast, she finds that the 'business judgment rule'¹⁰⁵ — introduced under the same legislation and protecting directors from personal liability in relation to informed business decisions made in good faith and in the best interests of the company — is likely to provide substantial protection to directors at the expense of the shareholder's interest.¹⁰⁶

It is probably axiomatic that the type of claim sought to be brought by a current or past minority shareholder through a statutory derivative action will be

¹⁰² (2001) ACLC 213.

¹⁰³ *Ibid* 214.

¹⁰⁴ Mitchell, above n 67, 81.

¹⁰⁵ *Corporations Act 2001* (Cth) s 180(2).

¹⁰⁶ Mitchell, above n 67, 74.

a claim that neither the board nor management is keen to bring. In terms of recent corporate history, a likely candidate for such action might be an attempt to reverse the 'huge golden parachutes' in situations of 'terminations attributable to unacceptable performance'.¹⁰⁷ This is the practice of paying multi-million dollar termination packages so that chairpersons or chief executive officers 'go quietly', often in situations where the latter may have shown poor judgment and made bad decisions leading to loss of shareholder value.

It is difficult to see leave being granted in such a situation. A major difficulty for such an action is that the rebuttable presumption contained in s 237(3), that granting leave is not in the best interests of the company, would appear to come into play in relation to a former director who had left more than six months prior to the commencement of proceedings.¹⁰⁸ If the company has made the payout as a settlement of a claim, it may be difficult to prove that the directors who approved the decision did not act in good faith for a proper purpose, if the only allegation against them is that they were too generous with company funds. Further, public companies have specific requirements of member approval for most such payments,¹⁰⁹ making it very unlikely that a court would seek to inquire into such a matter where member approval for the payment appears to have been granted.

Even if leave to take action is obtained, it is difficult to see how such a claim would succeed. A shareholder seeking to bring action by the company to recover such a payment will presumably try to argue that the payment was made under a mistake of fact or law. Yet they will undoubtedly find that the settlement had been made pursuant to extensive written legal advice, thus making a claim of mistake very difficult to support. Further, the former executive will likely fiercely resist such a claim. The derivative claimant might be better off trying to recoup by attempting to formulate an offsetting damages claim against the executive for negligent performance of their duties. However, this will be difficult to quantify and prove without internal assistance and will be subject to the 'business judgment rule' defences referred to above.

Another difficulty with derivative actions generally, is that in some cases persons complaining of misconduct will be persons who, by the time they are aware of the corporate misconduct, are no longer shareholders of the corporation (for example through a compulsory acquisition, capital reduction, takeover offer or merely a sale or disposal of shares). Though former members have standing to seek to bring a derivative action under s 236(1), the fact that any damages or relief will go to the corporation itself and will no longer benefit them (as they are no longer shareholders) means that there may be little incentive for them to seek to commence derivative proceedings.¹¹⁰

107 Australian Shareholders' Association, *Institutions Need to Show Leadership* (2001) Australian Shareholders' Association, <<http://www.asa.asn.au/Archive.asp?ArchiveID=147>> at 17 September 2002.

108 Harold Ford, Justice Robert Austin and Ian Ramsay, *An Introduction to the CLERP Act 1999 — Australia's New Company Law* (2000) [2.55].

109 See *Corporations Act 2001* (Cth) ss 200A, 200B, 200E, 208–27.

110 See generally Lang Thai, 'How Popular are Statutory Derivative Actions In Australia? Comparisons with United States, Canada and New Zealand' (2002) 30 *Australian Business Law Review* 118.

To date, few statutory derivative actions have been brought; where they have, the applicants have in most cases been unable to satisfy the courts as to the criteria for granting leave.¹¹¹

2 Representative Proceedings by Shareholders

Since 1992, the *Federal Court of Australia Act 1976* (Cth) has made available the remedy of representative proceedings for situations where the multiple claims arise out of the same, similar or related circumstances.¹¹²

Section 33C provides:

(1) Subject to this Part, where:

- (a) seven or more persons have claims against the same person; and
- (b) the claims of all those persons are in respect of, or arise out of, the same, similar or related circumstances; and
- (c) the claims of all those persons give rise to a substantial common issue of law or fact;

a proceeding may be commenced by one or more of those persons as representing some or all of them.

This provision arose out of a 1988 Australian Law Reform Commission report,¹¹³ which identified various multiple wrong situations — unlawful or wrongful injury, loss or damage caused to multiple persons — where group proceedings might be utilised. For example:

A group of small shareholders suffer considerable financial loss as a result of misleading advice received from stockbrokers and the directors of the company in which significant amounts of their savings were invested. The shareholders also claim that the company failed to comply with the Australian Stock Exchange listing rules by neglecting to inform the market of factors likely to materially affect the market price of shares. Apart from rights in negligence against the stockbrokers, the shareholders would have had rights against the directors arising from the Companies Code and the Securities Industry Code. A group proceeding could facilitate the recovery of loss by those affected and would offer the advantage of helping to ensure that all concerned were informed of the claim and shared in the result without having to commence individual proceedings.¹¹⁴

In the US, representative proceedings by shareholders, referred to as 'securities class actions' have been recognised as an important element in regulatory enforcement and part of the wider issue of corporate governance. In *Basic Inc v Levinson*,¹¹⁵ the US Supreme Court noted that it had 'repeatedly ... described the fundamental purpose of the [1934 United States Securities and Exchange] Act as implementing a philosophy of "full disclosure"'.¹¹⁶ The Court went on to note that the private right of action under s 10(b) of that Act and

111 See *Karam v ANZ Banking Group Ltd* (2000) 34 ACSR 545; *Advent Investors Pty Ltd v Goldhirsch* (2001) 37 ACSR 529; *Jeans v Deangrove Pty Ltd* [2001] NSWSC 84 (Unreported, Santow J, 23 February 2001); *Talisman Technologies Inc v Qld Electronic Switching Pty Ltd* [2001] QSC 324 (Unreported, Mullins J, 7 September 2002). Cf *Keyrate Pty Ltd v Hamarc Pty Ltd* (2001) 38 ACSR 396.

112 Note that pt 4A of the *Supreme Court Act 1986* (Vic) substantially mirrors the federal class action provisions.

113 Australian Law Reform Commission, *Grouped Proceedings in the Federal Court*, Report No 46 (1988).

114 *Ibid* 33.

115 485 US 224 (1988).

116 *Ibid* 223–32.

Securities and Exchange Commission Rule 10b-5 'constitutes an essential tool for enforcement of the 1934 Act's requirements'.¹¹⁷

The securities class action, in Australia termed a 'shareholders representative proceeding', must be distinguished from a derivative action. The former is a claim by one or more shareholders on behalf of numerous shareholders for personal losses suffered by them. The latter is a claim by a shareholder suing in the company's name for losses suffered by the company.¹¹⁸ The distinction is of practical significance as damages received in a shareholder representative proceeding are paid to individual shareholders, whereas damages received in a derivative action will be paid to the corporation itself. The benefit to shareholders of the latter will be indirect and at best may be reflected in a slight increase in the share price. However, in a very large corporation the derivative claim would need to be extremely large to have any discernible effect.

Earlier in this article I outlined the law in relation to misleading or deceptive conduct, and non-disclosure which may in some cases itself amount to misleading or deceptive conduct. Shareholder class actions may provide a remedy in the case of misleading or deceptive conduct by corporations, their directors, auditors and consultants (including merchant banks and accountants who act as 'independent experts'). In relation to insider trading, s 1317HA of the *Corporations Act* enables shareholders to commence proceedings for compensation against those responsible for insider trading. By virtue of ss 1043L(3) and 1043L(4), shareholders (buyers) or former shareholders (sellers) may seek damages in relation to the trading and procuring offences by reference to the difference between the amount actually paid and the amount that would have been paid had the information been generally available.

In civil actions against auditors, their potential accountability may be significantly reduced by the CLERP 9 recommendation that auditors be allowed to incorporate¹¹⁹ and that proportionate liability of auditors be introduced to replace joint and several liability.¹²⁰ The first proposal opens up the possibility that high risk auditing work could be performed by separate companies with limited assets and limited insurance which, in a situation of large negligence claims may fail and become insolvent to the detriment of those who have claims against them (including those who relied on their audit work and suffered loss as a consequence). The second proposal is likely to necessitate a significant revision of the current law of causation in relation to negligence. It is not clear why such a revision is warranted given that it will have the effect of privileging auditors above other types of defendant in proceedings. Taken with the extremely weak nature of the proposed reforms on auditor rotation and conflict of interest discussed above, the CLERP 9 proposals significantly improve the position of auditors at the expense of the rights of shareholders to seek compensation from them for negligent auditing of financial reports.

117 Ibid 232.

118 See generally Pamela Hanrahan, 'Distinguishing Corporate and Personal Claims in Australian Company Litigation' (1997) 15 *Companies and Securities Law Journal* 21.

119 CLERP 9, above n 58, 93.

120 Ibid 96.

It is not yet clear how effective securities class actions will be in Australia in obtaining redress for small shareholders from corporate misconduct and improving corporate governance. Whilst there is significant potential for these class actions,¹²¹ there are, however, significant practical cost impediments to such actions including the liability of representative parties for potentially huge costs if unsuccessful (even in 'public interest' cases)¹²². Further, such matters tend to be vigorously defended. Given the significant financial resources of large public companies, auditing firms and other insured parties, the costs of prosecuting them are generally beyond the resources of private individuals.

The most significant example of such a proceeding to date in Australia is the action brought by former GIO shareholders against the former GIO Australia Holdings Ltd, its independent expert Grant Samuel and Associates, and the former GIO directors. The action alleges misleading and deceptive conduct and negligence in relation to advice about the 1998 AMP takeover offer. That proceeding is yet to go to trial, though it has survived a major challenge to its representative structure.¹²³

VIII CONCLUSION

The number of shareholders in Australia has grown substantially in recent years. More than half the adult population now own shares. However, the role of small shareholders in corporate governance through their voting rights is substantially limited by the nature of corporate democracy, where voting rights attach to shares rather than to shareholders. Small shareholders suffer particularly from corporate misgovernance and malpractice, including insider trading, poor disclosure, misleading statements and poor financial reporting. The CLERP reforms of the late 1990s perceptibly weakened the position of small shareholders in relation to compulsory acquisition and capital reductions. The reforms have also provided defences to civil claims for misleading and deceptive conduct, making such claims harder to prosecute successfully. Further, it seems doubtful that the new statutory derivative action — though ostensibly a clarification and strengthening of a shareholder right — will be of any significant benefit to small shareholders.

The proposed CLERP 9 reforms appear to offer some minor improvements in the area of corporate disclosure. However, they weaken the ability of small

121 See especially Peta Spender, 'Securities Class Actions: A View from the Land of the Great White Shareholder' (2002) 31 *Common Law World Review* 123. See also Julian Donnan, 'Class Actions in Securities Fraud in Australia' (2000) 18 *Companies and Securities Law Journal* 82.

122 Donnan, above n 121, 90. See also Peter Cashman, 'Private Enforcement of Competition and Consumer Protection Laws: The Need for Financial Incentives to Achieve Corrective Justice' (Paper presented at the Competition and Consumer Protection Law Enforcement Conference, Sydney 4-5 July 2002), <<http://www.accc.gov.au/docs/conference/enforcement/papers.html>> at 27 September 2002.

123 See *King v GIO Australia Holdings Ltd* (2000) 100 FCR 209; *King v GIO Australia Holdings Ltd* [2000] FCA 1543 (Unreported, Wilcox, Lehane and Merkel JJ, 1 November 2000).

shareholders to obtain redress where they have suffered loss as a consequence of relying on a negligently performed audit.

Representative proceedings, introduced into the Federal Court in 1992 (and more recently in Victoria) appear to be one of the few areas where the position of small shareholders has been improved through procedural mechanisms that will provide for the practical private enforcement of existing law and for remedies of compensation to small shareholders affected by some types of corporate misconduct. There are, however, substantial cost impediments to such actions and significant hurdles for small shareholders in obtaining evidence.

It is unfortunate that the legislature can be seen to have watered down protections for small shareholders at a time when such shareholders are more numerous than ever and the government is effectively advocating increased share market participation through the sale of its remaining shares in Telstra. Compounding this sense of poor timing are the significant and high profile instances of corporate misconduct. An obvious question is whether legislation directed to providing extra protections specifically for small share investors has become necessary. The CLERP amendments in 1999 already seem to recognise a distinction between small shareholders and larger investors, in removing certain statutory protections for sophisticated investors.¹²⁴

If legislative solutions are considered impractical and we are left with a share market that cannot be made relatively fair for small investors, then we are forced to ask the question whether small investors should be in the market at all. It is not inconceivable that fund managers could aggregate and represent small investments, as occurs with the superannuation of wage and salary earners. Given the economic and political realities, however, this appears an unlikely scenario. It would also call into question the political process by which public assets have been privatised over the last ten years. It seems clear that this has been justified to a large degree on the availability and attractiveness of share issues to small investors. Further, recommendations by directors to policyholders in favour of demutualisation based on the tangible proprietary interest provided by shares would also become questionable. Ultimately, if small investors are to be a part of the capital markets, the legislature needs to have regard not only to improving corporate governance generally, but specifically ensuring that small investors are not unfairly disadvantaged relative to larger investors.

As the words of George W Bush make clear,¹²⁵ the capitalist corporation relies on a high measure of honest behaviour and accurate accounting to its shareholders and the markets in order to work properly. Strong and well-enforced laws against fraud and deceptive practices will buttress such behaviour for the benefit of small and large shareholders. If small shareholders do not feel that it is safe to invest then larger shareholders are likely to feel increasingly uneasy too. The recent events in the US show how quickly investors can lose faith in capital markets, with attendant ill effects throughout the economy.

124 *Corporations Act 2001* (Cth) s 708(8).

125 Above n 1.