DUE DILIGENCE IN SME FUNDRAISING: REFORM CHOICES, ECONOMICS AND EMPIRICISM

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This article analyses proposals for the reform of disclosure rules applying when a small medium enterprise (SME) makes a primary offering of securities. The article criticises these proposals on the following grounds. Firstly, the proposals seem to assume the value of coupling a due diligence requirement with *in terrorem* liability, rather than investigating this issue empirically. Secondly, given evidence and analytical predictions of serious underproduction of information regarding SMEs, and little or no knowledge of the investment analysis process by SME investors, the proposals advanced are likely to misspecify and distort the process by which information is furnished to investors when investments are made. The proposals also do not ensure investors have adequate information to monitor and direct management after their investment is made. Thirdly, the proposals ignore (and may exacerbate) the serious collective action problems of SME shareholders. Fourthly, the proposals ignore the considerable insights of institutional economics for SMEs with assets of low redeployability. Given these problems, a new proposal for SME fundraising is advanced, which is oriented towards fewer shareholders holding larger shareholdings with expanded rights to information. The paper concludes with an analysis of some of the problems for SME investors posed by other parts of corporate law, especially takeover requirements and directors' duties.

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I. INTRODUCTION

A major theme in the 1996 Federal election campaign of the Liberal and National Parties, which culminated in their landslide victory in the House of Representatives, was offering "a new deal for small business".[1] A significant aspect of this 'new deal' was to reduce the extent of regulation of small and medium sized enterprises (SMEs).[2] While the spotlight concentrated on industrial relations and taxation issues, an important part of this Platform concerned the reform of fundraising by SMEs. The policy document proposed a role for the Government in encouraging new options for access to "patient" equity capital for these enterprises.[3] However, the policy document also stated:

> Currently, there is a lack of adequate data on the performance, operation and profitability of small and medium businesses. This is a major impediment to corporate financiers seeking to lend to businesses ...[4]

Apparently, given such premises, the necessary policy was to:

> ...amend the *Corporations Act* [sic] to free smaller businesses from the regulatory impediments and costs of seeking capital from new investors, by exempting them from the onerous prospectus requirements.[5]

The critic may object to such a policy on logical grounds, notwithstanding his or her concurrence with the desirability of reviving small business in Australia. According to conventional wisdom, the prospectus document provides investors with information needed to assess the potential returns and risks of the investment. If it serves any purpose, a mandatory prospectus regime serves to increase the information content in the prospectus and render that information more accurate. If information is a barrier to investing, as the Coalition accepts, exempting corporations from the prospectus regime seems to reinforce that barrier. Is this inconsistency simply part of the public 'party line' justification for a policy designed to appeal to swinging voters with interests in SMEs, or is there an important issue of reconciling information asymmetries in SMEs with a prospectus regime?

Paralleling these machinations in the democratic polity, and as part of the Corporations Law Simplification Program commenced by the former government,[6] the Simplification Task Force issued a proposal dealing with fundraising, inviting submissions on various aspects of the prospectus regime.[7] Inter alia, the Task Force reconsidered two important exemptions: the twenty "personal" offers per year[8] and the $500,000 "gold card" exemptions.[9] The Task

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1 Liberal and National Parties, *A New Deal For Small Business: The Coalition's Small Business Policy*, February 1996.

2 *Ibid* at 4, 6.

3 *Ibid* at 13.

4 *Ibid.*

5 *Ibid.*

6 Apparently supported by the incumbents: see "New Coalition Government Pledges Supervision, Not Regulation" (1996) *Butterworths Corp L Bull* (No 5) 4 at [71].

7 Corporate Law Simplification Task Force, *Proposal on Fundraising & Trade Practices Act, s 52 and Securities Dealings*, November 1995.

8 *Corporations Law*, ss 66(2)(d), 66(3)(d).

Force proposed to clarify the former exemption by emphasising that the count was of issues, not offers.[10] However, the latter exemption was to be tightened up, by clarifying that $500,000 is the threshold for the amount invested, not the amount offered.[11] In making these proposals, the Task Force had regard to a report of the National Investment Council, which recognised the onerous nature of the prospectus regime for SMEs.[12] However, the Task Force rejected one of the recommendations of the Council to reduce the 'gold card' exemption to $250,000.

Can we conclude that, given bipartisan support, exempting SMEs from the prospectus regime is, to some degree, a desirable policy objective? In this article, I argue that the desirability of exemptions is partially an empirical question concerning the effects of the prospectus regime; that the nature of the evidence that must be collected needs to be determined by economic analysis; and that institutional economics has a fundamental role to play in formulating and appraising reform choices. A central question that needs to be addressed is the value of the mandatory due diligence examination. Significant costs of disclosure will usually be incurred (whether or not SMEs are exempt from the *Corporations Law* regime), as investors inevitably require information which the corporation is likely to produce at the lowest cost. However, in the absence of regulatory liability, the inquiries undertaken to reveal and verify this information are likely to vary according to several factors, such as the investor's familiarity with management and the complexity of the corporate business. However, prospectuses that do not attract exemptions under the *Corporations Law* (such as those referred to above) must be investigated to a predetermined standard. The diligence must be 'due', or those associated with the issue can face *in terrorem* liabilities for misstatements and omissions.[13] In this article, prospectus liability and mandatory due diligence are regarded as the principal issues in the exemption debate for SMEs. Policy makers must therefore consider three questions. Firstly, what is the benefit of due diligence? Secondly, how is a legal regime based in mandatory due diligence to be reconciled with capital formation in SMEs? Thirdly, can SME investment be encouraged without due diligence? This article addresses these questions in a framework of theoretical and empirical economics.

In Part II, the National Investment Council is analysed. The report, assumed to represent our best understanding of the capital formation process in Australian SMEs, predictably describes the prospectus regime of the *Corporations Law* as problematic for SME fundraising. However, the report also documents two inherent problems for SME investment. The first problem is moral hazard and adverse selection problems resulting from endemic information asymmetries between investors and managers. Secondly, the report addresses serious agency

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9 *Ibid*, ss 66(2)(a), 66(3)(a), 66(3)(ba).

10 See note 7 *supra*, at 11.

11 *Ibid.*

12 National Investment Council, *Financing Growth: Policy Options to Improve the Flow of Capital to Australia's Small and Medium Enterprises*, August 1995. See also text accompanying footnotes 15-26.

13 *Corporations Law*, ss 996, 1005-11. Reconciling these liability provisions is another object of the Task Force proposal, note 7 *supra* at 15-16. It is proposed that damages actions regarding a prospectus are to be limited to s 996, which does not apply to excluded issues: see *Corporations Law*, s 996(1)(a).

problems flowing from the separation of ownership and control in many SMEs likely to need external finance. This part therefore establishes the problem that must be dealt with in the reform of SME financing: how can one facilitate flexible, inexpensive capital raising in SMEs, while protecting investors under conditions of agency problems and asymmetric information?

Given these structural parameters, Part III uses theoretical and empirical economics to analyse the role of mandatory due diligence and *in terrorem* liability. The focus in this part is not limited to SMEs. This section seeks to analyse the purpose of due diligence generally in order to clarify the purpose it serves. In this part, I examine empirical evidence associated with the pricing efficiency of the primary securities market, including a study by Professors Ian Ramsay and Baljit Sidhu, of the relationship between underpricing of Initial Public Offerings (IPOs) and due diligence investigation.[14]

Having clarified the importance of due diligence, the final part of the article tries to ascertain whether these benefits can be secured in a substantially changed fundraising system that addresses the structural problems confronting investors in SMEs. The article critiques the proposals for SME fundraising 'reform', and uses institutional economics to develop a novel proposal for encouraging SME investment.

II. 'FINANCING GROWTH': THE NATIONAL INVESTMENT COUNCIL REPORT

The National Investment Council's report analysed the costs, risks and impediments affecting the flow of finance to SMEs.[15] The report concentrated on SMEs whose securities were not listed on the ASX. Of these, it paid special attention to 'high growth' SMEs. High growth SMEs require significant equity investment. Debt finance cannot often be utilised because of the SMEs' inability to make regular debt servicing payments from what is frequently a negative net cash flow position.[16] The report identifies two important common features of high growth SMEs: they rely on significant 'outside' equity, and decision-making is generally delegated to managers with little or no ownership stake.[17] Thus, ownership and control are separated. While this phenomenon is generally associated with larger corporations, the complexity of the management function may make the separation and specialisation of risk bearing and management an efficient structure in small enterprises.[18] Separation of ownership and control can create incentive problems, the effects of which are described as "agency costs".[19]

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14 I Ramsay and B Sidhu, "Underpricing of Initial Public Offerings and Due Diligence Costs: An Empirical Investigation" (1995) 13 *Company & Securities Law Journal* 186.

15 National Investment Council, note 12 *supra*.

16 See also text accompanying footnotes 135-7 *infra*.

17 National Investment Council, note 12 *supra* at 16.

18 E Fama and M Jensen, "Separation of Ownership and Control" (1983) 26 *J Law & Econ* 301 at 305-9.

19 See M Jensen and W Meckling, "Theory of the Firm: Managerial Behaviour, Agency Costs, and Ownership Structure" (1976) 3 *J Fin Econ* 305. Jensen and Meckling are identified as the original exponents of agency theory. This theory seeks to model the problems arising from disparate incentives of

Importantly, there are reasons to believe, *a priori*, that these agency costs may be substantial in high growth SMEs. This is because the Council's report explains that many SMEs lack proper management and corporate governance practices.[20]

The main investor types in SMEs are private investors (fulsomely described as "business angels") and institutional investors. Institutions normally operate through superannuation funds or specialist venture or development capital funds. Business angels normally lend up to amounts much lower than the minima for institutions, leading to a 'finance gap' between $500,000 and $2,000,000.[21] The report documents that the investment analysis processes of business angels are poorly understood. Of private investments that might be undertaken by business angels, the report states that a major difficulty is:

> ...[the market's] information inefficiency. It has been described as a '*giant game of hide and seek with everyone blindfolded*'. The market is characterised by widely scattered business investment opportunities and investors who prefer anonymity.[22]

The unavailability of information regarding investment opportunities in enterprises where (as noted above) agency problems are of very substantial dimensions, poses a challenge for reforming the regulation of SME securities. In the Council's report, many industry participants considered that the securities regulation system obstructed fundraising. As the prospectus content requirements of the *Corporations Law* are broadly and generally expressed,[23] the coercive quality of the civil liability provisions increases the cost of prospectus preparation by demanding significant research and review.[24] This is compounded by the difficulty of determining the necessary prospectus content for a SME given the fundamental differences between SMEs and larger corporations. Exemptions from the prospectus regime[25] were regarded as confused and confusing. Finally, establishing secondary markets in SME securities is difficult.[26]

The problems referred to in the report pose a paradox that is an important theme in this article. If, as the report suggests, the investment market is inefficient, a retreat from a prospectus requirement raises serious and complex issues. The major problem with SME investment seems to be the high potential for adverse selection by (and moral hazard to) investors, given pervasive information asymmetries. However, the prospectus regime is predicated on the soundness of using *in terrorem* liability and due diligence exculpation to compel those associated with the issue to eliminate such asymmetries. This issue forces us to reconsider the role of due diligence in capital formation. The next part of this article considers this role at a general level. Once these issues are clarified, the last part of the article examines whether the benefits of due diligence (actual or

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agents and principals, the means by which these problems can be addressed by contract law and market incentives, and the sharing of these costs between managers and residual claimants. See also E Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *J Pol Econ* 288.

20 National Investment Council, note 12 *supra* at 19-20.

21 *Ibid* at 31-2.

22 *Ibid* at 46 (footnote omitted from original, emphasis in original).

23 Section 1022.

24 National Investment Council, note 12 *supra* at 34.

25 For examples, see text accompanying footnotes 10-11 *supra*.

26 National Investment Council, note 12 *supra* at 36-8.

supposed) can be secured by alternative means in a fundraising system appropriate to SMEs.

III. THE LAW AND ECONOMICS OF DUE DILIGENCE IN CAPITAL ALLOCATION

A. Introduction

The purpose of this section is to review the empirical and theoretical analyses of the role of due diligence and mandatory disclosure in capital allocation. While the justification of this form of regulation must ultimately be empirical, the evidence collected to date does not justify either a strong view for or against due diligence. However, extant empirical evidence does not support an assertion that the *primary* market, in which corporations raise capital, is 'efficient' in any sense that would justify the wholesale disbandment of the mandatory disclosure system. The primary case put forward in this section of the article is that, if it were properly specified, a mandatory disclosure system for capital raising could have social value. Theoretical analysis justifies the preservation of significant liability directed towards the deterrence of fraudulent misstatement or omission. The following part of the article specifically addresses how, in an SME environment, the regulation of capital raising can be properly specified.

B. Due Diligence in a Mandatory Disclosure System: Australia and the USA

The connection between extensive liability for misstatement or omission in prospectuses with mandatory due diligence derives from the United States. The US *Securities Act* of 1933 (the 1933 Act)[27] was motivated by restoring public confidence in securities markets.[28] The Act requires corporations seeking to offer securities, to file with the Securities Exchange Commission (SEC) a registration statement making full disclosure of relevant information. Section 11(a) subjects persons involved with the issue to liability for material omissions or misstatements up to the value paid for the securities.[29] However, defendants apart from the issuer may plead the defence that they undertook a reasonable investigation, and had reasonable grounds to believe in the truth of statements.[30] This is the 'due diligence' defence.

The Australian provisions on prospectuses changed substantially with the introduction of the *Corporations Law*. Section 996 subjects those "authorising or causing" the issue of the prospectus to civil and criminal liability for material misstatements and omissions. For the purposes of civil actions brought under

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27 (1995) 15 USC §§ 77a- aa.

28 See statement of president Roosevelt to Congress regarding Bill of 1933 Act: Congressional Record (1933) 73rd Congress, 1st Session, pp 937, 954, as quoted in J Seligman, *The Transformation of Wall Street*, Houghton Mifflin (1982) pp 53-4.

29 (1995) 15 USC § 77k(a).

30 (1995) 15 USC § 77k(b)(3).

s 1005, s 1006 deems this group of defendants to include directors, experts whose statements are included in the prospectus, underwriters, auditors and other professionals acting in relation to the issue. Sections 1008A(4), 1009(4) and 1011 establish due diligence defences for persons besides the corporation.[31]

The concept of the prospectus/registration statement has been sharply criticised by scholars adopting an economic analytical perspective,[32] amongst other critics.[33] Complying with new issue disclosure requirements is costly,[34] and most information in the registration statement tends to be oriented towards the past, not the future.[35]

Under the original American system, disclosure was required not only under the 1933 Act when capital was raised, but also under the 1934 *Exchange Act* (the 1934 Act)[36] on an ongoing basis. The systems caused inefficient duplication, and were inconsistent in coverage and exemptions.[37] In 1980, a major reform occurred: registration forms were revised into a three tier system.[38] Those in the 'top' tier[39] were permitted to incorporate, by reference, information previously released, including filings under the 1934 Act. The analogous Australian system, which applies to corporations whose securities are Enhanced Disclosure securities,[40] requires a similarly identified group of corporations to disclose immediately any generally unavailable information that is material to the price of those securities.[41] The system also permits these corporations, when issuing securities, to use an abridged prospectus which need not include documents that are disclosed pursuant to continuous disclosure obligations.[42]

Nonetheless, there is a difference between these integrated disclosure systems. In the United States, documents incorporated into a registration statement by reference are subject to due diligence; in Australia it seems that this is not the case

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31 See also ss 996(2), 1008A(2) and 1009(3). For a discussion of the due diligence review, see A Hood, "Due Diligence Reviews for Fundraising Under the *Corporations Law*" in G Walker and B Fisse, *Securities Regulation in Australia and New Zealand*, Oxford University Press (1994) 401 at 404-9.

32 G Stigler, "The Public Regulation of the Securities Markets" (1964) 37 *J Bus* 117; G Benston, "The Value of the SEC's Accounting Disclosure Requirements" (1969) 44 *Acc Rev* 515.

33 H Kripke, *The SEC and Corporate Disclosure: Regulation in Search of a Purpose*, Harcourt Brace Jovanovich (1979).

34 S Phillips and R Zecker, *The SEC and the Public Interest*, MIT Press (1982) pp 44-52. Compare with F Easterbrook and D Fischel, "Mandatory Disclosure and the Protection of Investors" (1984) 70 *Va L Rev* 669 at 707-9.

35 C Schneider, "Nits, Grits and Soft Information in SEC Filings" (1972) 121 *University of Pennsylvania Law Review* 254 at 264-8; H Kripke, "A Search for a Meaningful Disclosure Policy" (1975) 31 *Bus Law* 293; C Saari, "The Efficient Capital Market Hypothesis, Economic Theory and the Regulation of the Securities Industry" (1977) 29 *Stan L Rev* 1031 at 1061-2. Compare with G Goldring, "Mandatory Disclosure of Corporate Projections and the Goals of Securities Regulation" (1981) 81 *Col L Rev* 1525; See also F Easterbrook and D Fischel, *ibid* at 702-3.

36 (1995) 15 USC §§ 78a-78ll.

37 See generally M Cohen, "'Truth in Securities' Revisited" (1966) 79 *Harv L Rev* 1340.

38 See *Securities Act* Release No 6235 (1980) CCH, *Fed Securities L Rep* at [82,649].

39 In brief, corporations reporting under the 1934 Act were in the 'top' tier if they issued investment grade debt, or the capitalisation of their voting stock exceeded a threshold: see *Securities Act* Release No 6383 (1982) *ibid* at [72,328].

40 *Corporations Law*, s 111AD.

41 See *Corporations Law*, Pt 1.2A, ss 1001A-1001D; Australian Stock Exchange, Listing Rule 3A(1).

42 See *Corporations Law*, s 1022AA.

for an abridged prospectus, as regards documents disclosed under the continuous disclosure requirements,[43] although these provisions do require reasonable care.[44] Underwriters in the USA regard this as a problem, because it requires the review of information which they had no responsibility for preparing.[45] This difficulty was compounded by the SEC's promulgation of rule 415, which enabled American corporations to register securities and then issue them with little or no delay at any suitable time over the ensuing two years.[46] In particular, the speed of taking the shares 'off the shelf' and offering them to buyers permitted very little time for due diligence.[47] This problem provided an opportunity to analyse the significance of due diligence to capital formation. The major theoretical analyses are considered in the next part.

C. Due Diligence and Theoretical Financial Economics

Banoff studied due diligence in shelf registrations. She rejected concerns regarding the compromise of due diligence on the basis of the financial economics theories of efficient capital markets and modern portfolio construction.[48] Banoff argued that while due diligence can be useful, by improving the information content of a prospectus, this advantage comes at a cost, given the nature of the investigation and the compensation that must be paid to underwriters and others to bear the risks of omission and misstatement. According to Banoff, the benefits do not justify the costs. Shareholders could reduce - Banoff says, "eliminate"[49] - risks associated with frauds or inaccuracies, which are risks specific to each issuing corporation, by acquiring shelf-registered shares as part of a diversified portfolio.[50] Portfolio theory teaches that security risk must be assessed, not in isolation, but in its contribution to the riskiness of the portfolio. That contribution depends on the co-variance of the security's return with those of other securities in the portfolio.[51]

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43 A Hood, note 31 *supra*, pp 417-18; R Baxt, H Ford and A Black, *Securities Industry Law*, Butterworths (5th ed, 1996) pp 64-5; G Golding, "Further, Further Prospectus Reforms" (1994) *Butterworths Corp L Bull* (No 1) 11 at [12].

44 Section 1001A(2)- "The disclosing entity must not contravene those provisions by intentionally, recklessly or *negligently* (my emphasis) failing to notify the securities exchange of information:..". See *Explanatory Memorandum, Corporate Law Reform Act* (1993) at [260].

45 See H Frerichs (Jr), "Underwriter Due Diligence Within the Integrated Disclosure System - If It Isn't Broken Don't Fix It" (1989) 16 *Sec Reg LJ* 386.

46 See B Banoff, "Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415" (1984) 70 *Va L Rev* 135; M Fox, "Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis" (1984) 70 *Va L Rev* 1005; D Green, "Note: Due Diligence under Rule 415: Is the Insurance Worth the Premium?" (1989) 38 *Emory LJ* 793.

47 *Securities Act* Release No 6423 (1982), note 38 *supra* at [83,250]. See [85,285]-[85,286] (dissent of Commissioner Thomas).

48 B Banoff, note 46 *supra* at 176-84. This article contains references to the literature on the Efficient Markets Hypothesis (EMH) and Modern Portfolio Theory. In relation to the EMH, its recent revisions and its application in Australia, see M Blair and I Ramsay, "Mandatory Corporate Disclosure Rules and Securities Regulation" in G Walker and B Fisse, note 31 *supra* at 275-7; M Whincop, "*Gambotto v WCP Ltd*: An Economic Analysis of Alterations to Articles and Expropriation Articles" (1995) 23 *ABLR* 276 at 288-9.

49 B Banoff, note 46 *supra* at 182.

50 *Ibid at* 182-3.

51 E Fama, *Foundations of Finance*, Basic Books (1976) pp 212-56.

Fox, while also applying an economic analysis, took issue with Banoff.[52] For Fox, the market's purpose is not limited to enabling investors to earn competitive returns, but serves to allocate capital in the larger economy. To fulfil this important function, the values the market assigns to securities must be accurate indicators of the underlying worth of the assets. Therefore, due diligence is important because it forces the disclosure of information needed for accurate pricing. It is not enough that security prices are 'unbiased', that is, that they are not systematically too high or too low. Unbiased but inaccurate prices will lead to capital misallocation. Fox acknowledges that his argument for due diligence has less relevance to secondary securities markets, where Banoff's diversification argument is sufficient. He relies on the importance of accurate prices in raising capital in primary markets and for the purposes of the operation of the market for corporate control, as well as for managerial reasons.[53]

If Banoff is right, the case for due diligence seems weak. If, however, Fox is correct, the case for SME exemptions is weakened. While I also embrace portfolio theory and the efficient markets hypothesis,[54] I have problems with both approaches. Fox's thesis depends on a construct that is not well established in finance. Fox argues, in effect, that it is desirable that prices closely approximate the fundamental value of the corporation. Gordon and Kornhauser describe this as "allocative efficiency",[55] and distinguish it from "speculative efficiency", which describes the inability of investors to systematically earn supra-competitive profits (ie profits exceeding the normal returns per unit of risk invested). Speculative efficiency requires the capital market to process information efficiently. Prices must adjust quickly and without bias to new information. While the evidence for speculative efficiency (which is at the heart of Banoff's case)[56] is respectable, it is tenuous for allocative efficiency.[57] One would expect this because a test of allocative efficiency presupposes a model for valuing *real* assets, a subject on which there is no agreement.[58] Stout has argued that the connection between primary markets and markets for corporate control, on the one hand, and secondary markets, on the other (in which the information will have its major impact by market clearing processes), is indirect at best.[59] Primary markets and markets for

52 M Fox, note 46 *supra.*

53 The contribution of market efficiency to the larger economy was criticised by Stout: L Stout, "The Unimportance of Being Efficient: An Economic Analysis of Stock Market Pricing and Securities Regulation," (1988) 87 *Mich L Rev* 613 at 659-61, 678-96.

54 Albeit with qualifications that have emerged since Fox and Banoff wrote. As to these problems, see F Black, "Noise" (1986) 41 *J Fin* 529; See also E Fama, "Efficient Capital Markets II" (1991) 46 *J Fin* 1575. For an analysis of these problems by legal scholars, see J Gordon and L Kornhauser, "Efficient Markets, Costly Information and Securities Research" (1985) 60 *NY Uni L Rev* 761; D Langevoort, "Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited" (1992) 140 *University of Pennsylvania Law Review* 851; R Booth, "The Efficient Market, Portfolio Theory and the Downward Sloping Demand Hypothesis" (1993) 68 *NY Uni L Rev* 1187.

55 J Gordon and L Kornhauser, *ibid* at 766-70.

56 See text accompanying footnotes 49-51 *supra.*

57 J Gordon and L Kornhauser, note 54 *supra*, 826-30; Compare with D Fischel, "Efficient Capital Markets, the Crash and the Fraud on the Market Theory," (1989) 74 *Cornell L Rev* 907 at 912-15.

58 D Fischel, *ibid* at 914.

59 L Stout, note 53 *supra* at 686-93.

corporate control are affected by structural factors, such as underwriter compensation and the distortive effects of takeover statutes and defensive tactics, which would dominate any positive impact due diligence would have on allocative efficiency.[60] Therefore, a claim that due diligence improves allocative efficiency *sounds* intuitively correct, but is unlikely to survive violations of the *ceteris paribus* assumption. However, as discussed below,[61] I concur with Fox's argument concerning the effect of due diligence on capital allocation,[62] although I justify it on the basis of strong evidence of *speculatively inefficient* overpricing of securities offered in primary market transactions.

Banoff's argument is appealing for its theoretical simplicity. Many problems in regulating securities offerings might be regarded as academic if the market was speculatively efficient. If, on average, shares issued by the corporations earned the same risk adjusted rate of return as securities trading in the secondary market, there would be little justification for further regulation. It would not matter that frauds in prospectuses were more likely (in the absence of a due diligence requirement), as investors investing in a diversified portfolio of securities (acquired in both primary and secondary markets) would be protected by the market's assessment of the likelihood of frauds, impounded into the offer price. Unfortunately, this analysis only takes us so far. The question is ultimately empirical. The most important evidence concerning the role that due diligence can and should play in capital allocation concerns the pricing of securities offered to the public in IPOs and 'seasoned' equity offerings (SEOs), that is, those whose securities already trade in the secondary market. Regulators need to know whether the primary securities market is speculatively efficient in the sense described, and how, if at all, due diligence and the prospectus regime affect the pricing of securities.

D. Due Diligence and Empirical Evidence Concerning Capital Offerings

(i) Early Work

This part considers the implications and limitations of empirical evidence concerning speculative efficiency.

Empirical analysis of the contribution of legislative regimes has been conducted for over three decades, and was initially controversial. In the United States, Stigler tried to assess the contribution of the *Securities Acts* regimes to the new issues markets.[63] How did purchasers of new issues fare before (1923-7) and after (1949-55) the *Securities Acts*, compared to investors in existing firms? Stigler found that in both periods, purchasers suffered substantial declines (compared to purchasers of existing issues) as between the two periods; the relative returns to new issues were insignificantly different; but the variance of returns was much higher for the

60 *Ibid* at 659-61, 686-93.

61 See text accompanying footnotes 95-99 *infra*.

62 See also M Kahan, "Securities Laws and the Social Costs of 'Inaccurate' Stock Prices" (1992) 41 *Duke LJ* 979 at 1005-12.

63 G Stigler, note 32 *supra*.

period of 1923-7. Stigler's article led to arguments about methodology and interpretation.[64] Subsequently, Jarrell 'confirmed' these results.[65]

Do these results inform analysis of the efficiency of the market for primary offerings, or of the contribution to that efficiency by the prospectus regime? Stigler had earlier commented that volatility measures ignorance in the market. Some therefore argued that decreasing ignorance is a positive benefit of the prospectus regime.[66] However, a measure of volatility is of little interest. What *is* of interest, which none of these studies tell us, is the extent to which this risk could be diversified.[67] The more risky company securities effectively excluded by the *Securities Acts* regime might have offered higher negative co-variance than the less risky issues. This would decrease the ability to structure *less* risky portfolios.[68] Further, there may be significant benefits which do not show up in either returns or volatility.[69] Finally, there is a methodological problem with the analysis of volatility. There is no expectations model regarding what volatility should be in new issues at various times.[70] That it differs across time is more probable than it remaining the same.

The studies do suggest that new issues are poor performers.[71] To the extent of the methodological soundness of the results, this suggests that offered stock is systematically overpriced. This is a serious problem for arguments that assume the diversifiability of misleading statements or errors in the prospectus, or, as Banoff asserts,[72] fraud.

Simon revisited Stigler and Jarrell's findings.[73] Using a stronger experimental design, Simon demonstrated that the 1933 Act had a significant influence on the returns (and not just the variance) of securities distributed in an IPO where the issuer was not listed with the New York Stock Exchange (NYSE). The NYSE had more demanding information requirements than other Exchanges. This conclusion did not extend to seasoned offerings of non-NYSE corporations. According to Simon's study, NYSE securities (both IPOs and SEOs) did not earn significant positive or negative abnormal returns. The finding that volatility decreased substantially after the *Securities Act* is confirmed, and applies to IPOs and SEOs,

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64 I Friend and E Herman, "The SEC Through a Glass Darkly" (1964) 37 *J Bus* 382; G Stigler, "Comment" (1964) 37 *J Bus* 414.

65 G Jarrell, "The Economic Effects of Federal Regulation of the Market for New Security Issues" (1981) 24 *J Law & Econ* 613; Compare with R Smith, "Comments on Jarrell" (1981) 24 *J Law & Econ* 677 (criticising research design) and C Simon, "The Effect of the Securities Act on Investor Information and the Performance of New Issues" (1989) 79 *Am Econ Rev* 295 (discussed below at text accompanying footnotes 73-4).

66 I Friend and E Herman, note 64 *supra* at 390-1; J Coffee, "Market Failure and the Economic Case for a Mandatory Disclosure System" (1984) 70 *Va L* Rev 717 at 734-6. G Stigler rejected this argument note 32 *supra* 32 at 122; See also note 64 *supra* at 418-19.

67 See also F Easterbrook and D Fischel, note 34 *supra* at 712.

68 Compare with R Posner and K Scott, *The Economics of Corporation Law and Securities Regulation*, Little Brown and Company (1980) p 379.

69 See text accompanying footnotes 81-5 *infra*.

70 Compare with C Simon, note 65 *supra* at 298, 310-11, see also footnote 7; R Pindyck, "Risk, Inflation and the Stock Market" (1984) 74 *Am Econ Rev* 335.

71 See text accompanying footnotes 95-99 *infra*.

72 B Banoff, note 46 *supra* at 181.

73 C Simon, note 65 *supra*.

irrespective of home Exchange. Simon found the change in volatility was not attributable to the 1929 Crash, but acknowledges other great changes in the period confound tests of a hypothesis seeking to attribute the change to the *Securities Act*.[74]

Simon's more discriminating experimental design shows the significance of prospectus information in smaller corporations making capital offerings, where disclosure is not mandated or available through alternative sources, a finding that is important to SME capital allocation.

(ii) Ramsay and Sidhu

Ramsay and Sidhu investigate the extent of underpricing in IPOs subject to *Corporations Law* fundraising requirements.[75] Underpricing refers to the difference between the price at which one can subscribe to stock in the primary market and the price at which the stock trades on its first trading day. The authors hypothesise that underpricing is attributable to information asymmetries between investors and managers, which due diligence is expected to reduce.[76] The conclusions are that substantial underpricing is observed to a degree similar to underpricing prevalent in issues subject to the *Companies Code*.[77] Secondly, there seems to be no significant correlation between the extent of due diligence undertaken and observed underpricing.

Ramsay and Sidhu state that:

> [i]f due diligence costs do not result in more accurate pricing of IPOs then an important issue is raised regarding the value of these costs. However, it may be that due diligence requirements serve purposes other than more accurate pricing of IPOs. We leave for further investigation what these other purposes might be.[78]

Ramsay and Sidhu's proxy for due diligence costs may not capture the full extent of due diligence examination costs and may not be measuring the variable of interest. Their hypothesis is that the more extensive the due diligence, the more likely is the elimination of information asymmetry, and the lower the underpricing. However, due diligence costs disclosed in the prospectus may not be a discriminating measure of the extent of the due diligence investigation. Firstly, the cost of due diligence may be greater for some corporations' businesses than others, depending on the need for expertise in investigation and verification.[79] Investigations might achieve the same level of coverage but differ greatly in cost. Secondly, directors may contribute extensively to due diligence examinations, however these costs are likely to be reflected in director compensation, not prospectus issue costs. Thirdly, the corporation itself, through its management and employees may do much of the core work in due diligence examination. If this

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74 *Ibid* at 313.

75 I Ramsay and B Sidhu, note 14 *supra*.

76 *Ibid* at 187-93.

77 The authors compare their results with Lee et al: P Lee, S Taylor and T Walter, *Australian IPO Pricing in the Short and Long Run*, Working Paper No 94/6, University of Sydney, Accounting Department, 1994.

78 I Ramsay and B Sidhu, note 14 *supra* at 199.

79 Consider a firm with a significant overseas operations, or a firm with 'high-tech' investment plans.

percentage is not highly positively correlated to the explicit issue costs, these will not be a reliable indicator for the experiment.[80]

Assuming that due diligence issue costs are a reliable proxy, there are three possible explanations for Ramsay and Sidhu's results:

(iii) Due Diligence and the Costs of Investment Analysis

The purpose of due diligence investigations may be to decrease the information search and analysis costs of market participants. Gilson and Kraakman made this point in their definitive article on market efficiency.[81] After analysing the early debates engendered by empirical analyses of the *Securities Acts'* mandatory disclosure requirements,[82] Gilson and Kraakman argue that these results do not prove that mandatory disclosure was not beneficial. One major benefit, the reduction of costs of analysts and other investors, would not be expected to be reflected in security returns.[83] Unless the information required to be disclosed was unavailable or available only at great cost prior to the mandatory requirement, one would not *expect* to see a reaction in returns.[84] The real benefit is saving analysis costs. This may be also true of the due diligence requirement in our system. Investors may decrease the search and verification costs that they otherwise would incur in the absence of due diligence.

If empirical evidence demonstrated a reduction in investor costs, a harder question arises. Gilson and Kraakman note that mandatory disclosure can be characterised as "relief legislation for professional traders with little or no immediate relief value to issuers or to the ostensible beneficiaries of the Act, the uninformed investing public." If so, policy analysis is needed to examine whether this subsidy is worth its costs.[85]

(iv) Due Diligence and Stock Overpricing

The analysis above noted Gilson and Kraakman's argument that the benefit of mandatory disclosure was unlikely to be observed in stock returns. That discussion concerns a mandatory disclosure requirement roughly equivalent to Australian corporations' obligations to lodge financial statements.[86] The discussion was not directed to the prospectus disclosure system when a corporation raises capital. Might due diligence have an observable effect on stock pricing? Answering this question requires a comparison between mandatory disclosure in primary and secondary markets.

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80 For an experimental design which may overcome some of these problems, see text accompanying footnote 103 *infra*.

81 R Gilson and R Kraakman, "The Mechanisms of Market Efficiency" (1984) 70 *Va L Rev* 549.

82 G Benston, note 32 *supra* See also G Benston, "Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934" (1973) 63 *Am Econ Rev* 132.

83 R Gilson and R Kraakman, note 81 *supra* at 636-42; F Easterbrook and D Fischel, note 34 *supra* at 711.

84 *Ibid at* 638.

85 For an analysis of this question from a novel economic perspective, see N Georgakopoulos, "Why Should Disclosure Rules Subsidize Informed Traders?" (1996) 16 *Int Rev L & Econ* (forthcoming, copy on file with author).

86 *Corporations Law*, s 317A. See also Australian Stock Exchange, Listing Rule 3C.

Gilson and Kraakman's argued that no effect on stock returns was observed in secondary markets when periodic disclosure was introduced because this information could previously have been secured by a sufficient number of traders to 'move the price' to the new equilibrium.[87] Is it possible that in primary market transactions, information provided pursuant to a regulatory requirement would not otherwise be available? An affirmative answer implies that there are different (lower) incentives to produce information in primary market transactions.[88]

In a secondary market, there are generally many buyers and sellers of securities. Traders will seek information suggesting the shares are mispriced. Good and bad news is equally profitable, provided that in 'bad news' situations, one can sell existing holdings, sell short, or buy put options. The search for gain is the search for information.[89]

In an IPO, opportunities for profit differ. There is only one seller, and the underwriter establishes a going price before trading begins.[90] One can buy at that price, or leave the securities alone. Discovering private 'bad news' during the offer period is of limited use. One cannot sell the stock until a distribution of securities is made. Puts in IPO securities are likely to be unavailable. Short selling is likely to be impermissible.[91] The value of the bad news can be nil if the investor estimates the stock is likely to be underpriced: in such a case, one wants to buy, not sell. Searching for information is not therefore attractive, because the opportunities for profitably exploiting bad news are limited. In contrast, a corporation will try to disclose as much good news as it possibly can without invoking prospectus liability for misstatement. Further, firms are likely to try to leak information that can't be put in the prospectus as widely as possible. Persons interested in making profits from private information will be discouraged from producing it if the size of the parcel of shares one obtains by subscription is uncertain. This will occur in an over-subscription, or if the minimum subscription figure has not been attained. Finally, a new corporation without a track record or a database of previous relevant facts is likely to be a more costly proposition for extensive research. Therefore, as Simon's evidence confirms,[92] there are *a priori* theoretical arguments that in primary market transactions, information may not be obtained by investors (in the absence of a rule imposing liability for violating a mandatory disclosure requirement on capital raising). This is because of limited private incentives to produce information, especially 'bad news' information that market participants will find costly to produce.[93]

How can these arguments be reconciled with Ramsay and Sidhu's result that there is no connection between due diligence and stock pricing? Ramsay and Sidhu do not directly study the relevant phenomenon. The authors hypothesise

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87 See text accompanying footnote 84 *supra.*

88 Compare with K Rock, "Why New Issues are Underpriced" (1986) 15 *J Fin Econ* 187.

89 R Gilson and R Kraakman, note 81 *supra* at 592-613.

90 Open pricing is an exception to this model, but is not prevalent in Australia: see M Earp and G McGrath, *Listed Companies: Law and Market Practice,* Law Book Company (1996) pp 114, 685-90.

91 *Corporations Law*, s 846; Australian Stock Exchange, Business Rule 2.18.

92 See text accompanying footnotes 73-4 *supra.*

93 See also C Simon, note 65 *supra* at 297.

that due diligence investigations decrease information asymmetries associated with IPOs, so decreasing the extent of underpricing. This hypothesis is contestable. The syllogism used to derive it suggests another conclusion. The major premise is that information asymmetries are decreased by due diligence investigation; the minor premise is that information asymmetries are reflected in underpricing. I argue for a different minor premise, related not to *short*-term *under* pricing but to *long*-term *over*pricing.[94]

Ramsay and Sidhu note (but do not investigate the implications of) the empirical evidence consistent with corporations that offer shares in an IPO underperforming the market.[95] In a study of the United States market, Loughran and Ritter demonstrate that corporations issuing stock under-perform the market returns of corporations that do not.[96] This phenomenon is not restricted to IPOs, but extends to corporations making 'seasoned' equity offerings. Loughran and Ritter find that other factors that might explain this low performance, such as size and the nature of the issuers as growth companies, do not adequately do so. Their conclusion is that to have the same amount of money at the end of five years as an investor in the stocks of non-issuers, an investor must invest about 44 per cent more capital.[97] The authors conclude that this result has much to do with corporations exploiting "windows of opportunity" when the corporation or the market are perceived to be overvalued.[98] A study of IPOs in Australian industrial companies between 1976 and 1989 showed significant overpricing: investors lost about half the value of their capital in three years.[99] This result suggests considerable inefficiency in allocation of capital resources. A speculative inefficiency of such magnitude suggests allocative inefficiencies,[100] a matter of concern to Fox.[101]

Do these results imply a need for prospectus disclosure and mandatory due diligence? An affirmative answer must assume overpricing is a consequence of information asymmetry. If so, the goal of due diligence would be to include information in the prospectus so as to reduce the asymmetry. Thus, due diligence would have merit if it cost less than the benefits of more accurate capital allocation. However, this rationalisation depends on a prospectus document's

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94 Theoretical argument supports a relationship between these two concepts: see K Rock, note 90 *supra*.

95 I Ramsay and B Sidhu, note 14 *supra* at 187-8. "It was not possible to do a long run underpricing study at the time because of the relatively recent introduction of the *Corporations Law*", E-mail communication from I Ramsay to author, 14 March 1996.

96 T Loughran and J Ritter, "The New Issues Puzzle" (1995) 50 *J Fin* 23.

97 See also J Shayne and L Soderquist, "Inefficiency in the Market for Initial Public Offerings" (1995) 48 *Vand L* Rev 965 (confirming this result).

98 The attentive reader will note the inconsistency between these results and those in Simon (see text accompanying footnotes 73-74 *supra*). The inconsistency can be explained as follows: (a) Simon studied considerably earlier periods; and (b) Simon uses a different experimental design to analyse abnormal returns from an Arbitrage Pricing Theory model, while Loughran and Ritter compare the returns from direct investment in IPOs and SEOs with the securities of corporations making no equity offerings bought in the secondary market. Neither experimental design is inherently 'superior'.

99 P Lee et al, note 77 *supra*. See also D Allen and M Patrick, *Some Further Australian Evidence on the Long-Run Performance of Initial Public Offerings: 1974-1984* Working Paper No 94/10, Department of Finance, Curtin University of Technology, 1994.

100 See text accompanying footnotes 55-60 *supra*.

101 See text accompanying footnotes 52-3 *supra*.

ability to convey information that improves the capital allocation. This is not obvious: Loughran and Ritter's results occurred in a mandatory due diligence environment. Also, the similarity in poor returns in IPOs and SEOs casts doubt on the value of due diligence because in the case of corporations making SEOs, the incentive of traders to produce information is not limited. Further, the seasoned corporation is already subject to mandatory continuous disclosure requirements. Ultimately, the question is an empirical one. I now turn to its possible testing.

Firstly, what hypothesis must be tested? The hypothesis would be that long term overpricing is inversely related to due diligence expenditure. Evidence supporting that hypothesis would suggest that due diligence has value because it decreases inefficiencies in capital allocation. An insignificant or zero correlation is not dispositive of the conclusion that due diligence has no value, because this evidence could be consistent with the argument that the benefit of due diligence flows through to investment analyst cost savings.

How might this hypothesis be tested? Ramsay and Sidhu's approach was a cross-sectional one, which correlated underpricing with due diligence expenditures in IPOs under the *Corporations Law*. An alternative approach is a cross-temporal test. Each IPO under the *Corporations Law* regime would be matched with an issue under the co-operative scheme regime, and, if possible, in a separate experiment, with an issue prior to the co-operative scheme regime. The goal would be to match as closely as possible, on such variables as size of the issue, the size of the corporation and the industry. This may not be easy. One would thus be comparing the overpricing observed under the *Corporations Law*, where a due diligence requirement exists, with overpricing of issues subject to regimes where due diligence was not mandatory. The advantages of this test are, firstly, that the experimental design introduces a quasi-control group (the earlier regimes), which enables comparisons with the *Corporations Law* regime.[102] Secondly, the test avoids the noted complication that the extensiveness of due diligence may not be strongly correlated with disclosed issue costs.[103] A mandated standard of due diligence may have the effect of equalising the extensiveness (though not the cost) of the search and verification of data, so making variation in stock mispricing difficult to detect within the *Corporations Law* regime sample.

(v) Due Diligence and Irrelevance

The final possible analysis of Ramsay and Sidhu's results (which assumes the invalidity of the above hypotheses concerning analysis cost and underpricing) is that due diligence serves no useful purpose.[104] The effect of the legal regime would be that the defendants listed in s 1006(2) (who are potentially liable for misstatement or omissions in the prospectus) become the guarantors of security

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102 The findings from this test could nonetheless be confounded. Firstly, a significant difference in underpricing may reflect the generalised content test in s 1022, not due diligence. The two requirements are simultaneously present and hard to distinguish. Secondly, other changes between the regimes (eg political, economic) may influence any difference between the groups.

103 Expenditure may reflect the difficulty of the investigation, not its extensiveness. See text accompanying footnotes 79-80 *supra*.

104 Compare with B Banoff, note 46 *supra* at 179; see text accompanying footnotes 49-50 *supra*.

performance. That guarantee is conditional on failure to perform due diligence. Such a regime is likely to be inefficient. Following Banoff, it may be cheaper to impose the risk of omissions or misstatements on shareholders. Omissions and misstatements may be favourable or unfavourable, although only unfavourable omissions are likely to occasion lawsuits. Shareholders are able to decrease potential losses by diversification across other share issues and other securities and assets in an inexpensive way, compared to a regime that imposes the loss on the professionals associated with the issue whose capacity to diversify the risk is more limited.[105] This is simply a question of who bears the costs most cheaply.

Even if shareholders do bear these risks most efficiently, the regime should subject those responsible for opportunistic or fraudulent misstatements or omissions to liability. Diversification of fraud is difficult. On this point, I disagree with Banoff, who argues that fraud is a company specific risk which diversification can eliminate.[106] Coffee's analysis is apposite:

> [T]he assumption that the market evaluates the risk of [fraud] on a firm specific basis needs re-examination. Much more likely is that the market makes this judgment not on a firm-by-firm basis but generically across a range of similarly situated stocks. Only those firms (notably few, I believe) that can credibly distinguish themselves from the herd through signalling, monitoring, or bonding will be separately and individually 'priced.' ... In short, there will be external effects, because bad managers will raise the cost of capital to good managers, unless the latter can credibly signal their higher virtue.
>
> [I]f the risk is really a systematic one (because all firms must incur agency costs), diversification is no longer a satisfactory remedy.[107]

These comments have particular force in an IPO, since the managers of IPO corporations may be new to the market. The change in governance arrangement that accompanies an offeror corporation with an established business becoming 'investment ready' presents new opportunities that the market may be unable to appraise meaningfully. Gordon has argued that opportunism cannot be diversified unless shareholders have in their portfolio some securities which equate with managers' outcomes.[108] Therefore, subjecting those responsible for fraudulent misstatements or omissions to *in terrorem* liabilities is efficient.[109] However, it

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105 Coffee has argued a case for mandatory disclosure because some investors rationally hold undiversified *security* portfolios in order to hold diversified *investment* portfolios: see J Coffee, note 66 *supra at* 748-9. Frequently, investors will hold interests in real property, or superannuation, for example. To the extent that this point applies to a mandatory due diligence requirement, it remains likely that the risk of equity securities resulting from omission or misstatement can be reduced given investment diversification. Shareholders remain the lowest cost bearer of such risks.

106 See text accompanying footnotes 49-50 *supra.*

107 J Coffee, "No Exit?: Opting Out, the Contractual Theory of the Corporation, and the Special Case of Remedies" (1988) 53 *Brooklyn L Rev* 919 at 945-6. See generally G Akerlof, "The Market for 'Lemons': The Quality of Uncertainty and the Market Mechanism" (1970) 84 *Q J Econ* 488 (under conditions of information asymmetry, where sellers find credible signals difficult to make, bad products will displace good ones).

108 J Gordon, "The Mandatory Structure of Corporate Law" (1989) 89 *Col L Rev* 1549 at 1594-5.

109 G Becker and W Landes (eds), *Essays in the Economics of Crime and Punishment*, National Bureau of Economic Research (1974). For a discussion of the implications of deterring opportunism in the context of s 232(2), (5) and (6), see M Whincop, "An Economic Analysis of the Criminalization and Content of Directors' Duties" (1996) 24 *ABLR* 273; see also text accompanying footnotes 65-72 *supra.*

does *not* follow that mandatory due diligence is an *efficient* solution to prospectus fraud. As between deterring fraud by imposing severe penalties on those responsible for it, and seeking to discover fraud by imposing severe penalties on those not responsible for it (who do not find it in a due diligence investigation) the former is likely to be more efficient. It places the responsibility on the person who knows of the opportunism, and can eliminate it at the lowest cost. It also reduces wasteful and unproductive costs of searching for opportunism.[110]

One clarification is needed. Even though evidence suggests IPO stocks systematically perform poorly, it does not follow that the risk from (non-fraudulent) omissions and misstatements is not diversifiable. The empirical evidence does not establish that overall poor performance is attributable to prospectus omission or misstatement.

Finally, coupling due diligence and *in terrorem* liability might be harmful. The most useful evidence in a prospectus is forward looking information, such as profit and dividend forecasts.[111] This information is also the most likely to prove to be wrong, thus invoking the prospectus liability provisions unless the defendant proves 'reasonable grounds' for the representation. This is likely to deter inclusion.[112] Future forecasts and 'soft information' are the least easy to verify or confirm in due diligence investigation. Exclusion of such information may be harmful to investors and cause inefficient capital allocation.

IV. 'AY, THERE'S THE RUB': DUE DILIGENCE IN SME FUNDRAISING

A. Reconceptualising SMEs: Collective Action and 'Voice'

In the preceding section, I identified three analyses of our regime's coupling of due diligence and *in terrorem* liability. Which of these analyses is correct is an empirical question. Only the underpricing hypothesis can be conveniently (although imperfectly) tested. The cost saving hypothesis is in principle falsifiable, but acquiring evidence on what would happen in the absence of the system is complex. Whether such a saving is supportable as 'Kaldor-Hicks' efficient[113] or whether the costs surpass the benefits (so supporting the irrelevance hypothesis) are difficult questions to determine. Given that all we know is *how* the prospectus regime *might* be beneficial, how might any proposal regarding SMEs proceed?

It is necessary firstly to identify the SME parameters that a fundraising regime must address. This requires identification of the matters that differentiate the SME investor from an investor in a larger listed corporation. It is suggested below that

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110 F Easterbrook and D Fischel, "Optimal Damages in Securities Cases" (1985) 52 *University of Chicago Law Review* 611 at 613, 621-2.

111 See text accompanying footnote 35 *supra*.

112 *Corporations Law*, s 765.

113 In other words, the benefits to the beneficiaries exceed the losses to the losers: for a critique of this concept, see G Calabresi, "The Pointlessness of Pareto: Carrying Coase Further" (1991) 100 *Yale LJ* 1211 at 1221- 8.

the key matters are to ensure investors are capable of monitoring management and exercising 'voice' regarding managerial issues, and to ensure the stability and durability of the relation between investors and management. Economics is used to elucidate important principles relevant to how voice and monitoring might be frustrated, and why economic relations may not be stable or durable. These concerns are taken up in this and the next part of this section.

The third and fourth sections of this part use these economic insights to critique the reform proposals outlined in the Introduction. I argue that these are deficient.

The fifth part advances a new proposal (or the elements of a proposal) that attempts simultaneously to solve three problems. Firstly, the proposal addresses the long term matters of voice and stability which I argue to be essential. Secondly, the proposal rejects the suitability of the present prospectus regime as likely to be misspecified, in favour of a more open-ended process of information exchange. Thirdly, the proposal retains legal rules that discourage the managers of corporations from relying on information asymmetry when the investment is made. I believe that the proposal conforms to the concept of 'responsive regulation', in the manner that Ayres and Braithwaite describe.[114] That is, the proposal seeks a form of regulation that avoids the extremes of deregulation and interventionist fiat, which responds to, and influences beneficially the structure of the SME 'industry'.[115]

The National Investment Council report identifies several problems in SME fundraising: serious information asymmetries between investors and managers, poorly developed corporate governance practices and consequent agency problems.[116] The report referred to the lack of liquid trading markets for SME residual claims. This has several consequences, some of which affect the level and means of control of agency costs. Firstly, investors are denied a workable 'exit' option until the investment succeeds, the corporation lists on an exchange, or somebody else can be found to take the investor's place. These events may never occur. Secondly, the lack of secondary markets means that disciplinary forces that operate through capital markets to reduce agency costs, such as takeovers, are blunted, provided the SME stays solvent and does not need capital for some time. Further, given the Council's finding that many SME managers lack the motivation to act in the interests of investors, these managers seem not to be 'repeat players' in the market for managerial labour.[117] If so, another market discipline is unavailable. Thirdly, other investors and speculators are unlikely to acquire information concerning the corporation on an ongoing basis, because the reward of profitable trading in the corporation's securities is unavailable. This reinforces information asymmetry.

The inability to 'exit' has the consequence that 'voice' is much more important to SME investors than to shareholders of listed companies. Shareholders in listed companies may follow the 'Wall Street Rule': vote with management or sell your

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114 I Ayres and J Braithwaite, *Responsive Regulation: Transcending the Deregulation Debate*, Oxford University Press (1992).

115 *Ibid*, pp 4-5.

116 See text accompanying footnotes 17-26 *supra*.

117 National Investment Council, note 12 *supra* at 19-20.

shares.[118] This is not possible in SMEs, so it is important for investors to have effective representation in management and governance. Clearly, in SMEs, there is a critical linkage between a securities regulation regime and corporate governance practices.

However, the ability for shareholders to 'raise' their 'voice' can be constrained by collective action problems.[119] Because of their importance, it is worth returning to an elementary analysis of the nature of collective action problems.[120] A purpose of most groups, such as the shareholders of a corporation, is to achieve some common interest. Shareholders have a common interest in the success of the corporation. Because managers, as agents, can imperil that success, shareholders have a common interest in ensuring that management is adequately monitored and operates subject to acceptable controls on their discretion. Olson points out that achieving a common interest is like providing a public good to group members.[121] For the benefits (such as the monitoring and control of management) to be available to anyone, they must be available to everyone. Olson's theory analyses whether a common interest will be achieved; and whether achieving it is only possible by entrusting coercive power to a group member to obtain the resources to procure the good. If there is some quantity of a collective good that can be obtained at a cost sufficiently low compared to its benefit (that some one person would gain from providing the good personally) the collective good will be provided without any need for members to agree to be coerced to make mandatory contributions to cost.[122] The ability of a group to obtain a collective good, and the extent to which the good obtained approaches the optimal level depends on the number of group members, the extent of the interest of the 'largest' member or members and, in cases where individual members will not provide the good voluntarily, the cost of co-ordination and organisation. Besides some form of coercion, it is necessary in the case of large groups where a collective good will not be obtained for there to be some 'selective' benefit conferred on an individual acting in a group-oriented way.[123] These issues are vital to analysing SME fundraising exemptions. The law must be responsive to collective action problems to which exemptions might contribute. It follows from Olson's work that fewer shareholders are preferable to more shareholders, and that larger individual shareholdings (in proportional terms) are preferable to smaller individual shareholdings. These options are more likely to ensure that the collective good - monitoring and constraining management - is obtained at a level that is optimal for the shareholder body. A larger number of shareholders, each with smaller interests, substantially decreases each shareholder's incentive to monitor and to exercise 'voice'. This reinforces asymmetric information and may increase agency costs. While this is also true of large corporations, the greater discipline of capital

118 See A Hirschman, *Exit Voice and Loyalty*, Harvard University Press (1970).

119 See B Black, "Shareholder Passivity Reexamined" (1990) 89 *Mich L Rev* 520.

120 The analysis derives from Olson's pioneering insights: M Olson, *The Logic of Collective Action: Public Goods and the Theory of Groups*, Harvard University Press (2nd ed, 1971).

121 *Ibid*, p 15.

122 *Ibid*, pp 22-5.

123 *Ibid*, p 51.

and managerial labour markets compensates shareholders for the depreciation of the value of voice.[124] In any event, the option of 'voice' seems to be increasingly important to institutional investors in larger corporations.[125] Black hypothesises that there are economies of scale in exercising voice where the matter concerned is common to a number of the corporations in which the institution invests.[126] This makes it possible for institutions to exercise voice, even with smaller proportional interests. However, there are no obvious economies of scale in exercising voice in SMEs where shareholders hold only small interests, especially where the finance sought is below venture capital fund minima. Black's most acute observation is that the ability and incentive for institutions investing in large corporations to exercise 'voice' is contingent: it depends on legal rules.[127] This point applies equally to SME fundraising. It is important that exemptions in the *Corporations Law* do not encourage shareholding profiles that lead to sub-optimal investment in monitoring and control.

B. Reconceptualising SMEs: Transaction Cost Analysis

The preceding section looked at problems deriving from the reduced ability for minimising agency costs through market disciplines. It is therefore important to ensure shareholders can exercise 'voice'. This part continues this theme by joining the analysis of shareholder 'voice' with a broader general framework of the governance of contractual relations. This framework is derived from institutional economics. This section thus articulates important insights of relational governance, which can be used to critique present proposals (and develop new ones) for the reform of SME fundraising. There is an important connection between this part and the preceding one. It was indicated in the preceding part that larger shareholder interests are necessary for shareholder voice to be expressed in the control of management discretion. However, *ceteris paribus*, bigger shareholdings decrease the ability of shareholders to diversify the risk associated with the shareholding. Therefore, the continued, stable existence of the corporation becomes much more important to the shareholder than is the case for a shareholder holding only a small portfolio interest. It follows that issues of 'voice' and relational stability are issues that must be addressed together.

Two powerful economic theories can be used to analyse the effect of opportunism on economic exchange. These are agency theory[128] and transaction cost economics (TCE).[129] In a comparison of the two theories, Oliver Williamson, the major exponent of TCE, noted two important differences which are presently

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124 See generally, M Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance*, Princeton University Press (1994).

125 B Black, note 119 *supra*; J Coffee, "Liquidity Versus Control: The Institutional Investor as Corporate Monitor" (1991) 91 *Col L Rev* 1277; G Stapledon, *Institutional Shareholders and Corporate Governance*, Oxford University Press (1996).

126 B Black, note 119 *supra* at 580-2. Black cites as examples, confidential voting and the structure of management compensation, inter alia.

127 *Ibid* at 525, 530-2.

128 Note 19 *supra*.

129 For the main analyses of TCE see O Williamson, *The Economic Institutions of Capitalism*, Free Press, (1986); see also O Williamson, *The Mechanisms of Governance*, Oxford University Press (1996).

relevant. Firstly, whereas TCE looks at the governance of relationships after they have been brought into existence, agency theory is concerned with the incentive alignments chosen when the relationship comes into being.[130] Secondly, in agency theory there is a much stronger sense of efficient incentives being the result of the market's natural selection processes.[131]

This article primarily adopts the TCE perspective, since TCE is naturally geared to analysing economic problems, such as SME investment, where the ongoing issue of the governance of contractual relations is paramount. For reasons already indicated, the weak incentives of markets for SME capital and managerial labour hold little promise of naturally selecting an efficient structure. In situations where asymmetric information is high, a reliance on market incentives to control agency problems seems to lead to the 'lemons' problem that prevents good investments from being distinguished from bad ones, and the departure of good investment from the market.[132] Therefore, in this case of market failure, the law must be receptive to the relationship of the parties after they have contracted. The law concerning fundraising must not encourage structures likely, ex post, to be unstable or vulnerable to opportunism. In other words, initial conditions have an important bearing on the durability of the relationship.[133]

The major analytical dimension of TCE is asset specificity. This refers to the value of an asset in its present use, compared to its value in an alternative use.[134] If this alternative use value is relatively low, the asset is highly 'specific', and vulnerable to opportunistic expropriation or hold-out behaviour by one of the parties to the relationship. TCE is concerned with efficient governance structures for the development of highly specific assets, given the threat of opportunism, the parties' limited information and computational ability, and costly contracting. The coalition of assets that makes up the economic activity of many SMEs, especially the 'growth' SMEs analysed in the Council's report, would seem to be of high specificity, because these coalitions depend on a nascent connection between an idea, a small core of managers with idiosyncratic abilities and a productive facility.

Williamson has shown how debt and equity can be regarded as alternative governance structures.[135] Debt is a rule based structure. Rules are specified in advance. Lenders are entitled, in the event of default in complying with these rules, to exercise a pre-emptive claim, via security, against the assets of the corporation. However, as redeployability of an asset decreases (ie, its specificity rises), the terms according to which debt will be made available become increasingly costly, as the value of pre-emptive claims falls. Equity replaces rule based governance with governance that is essentially administrative. Few rules are specified *ex ante*. To safeguard investors, they must be given rights ('voice') regarding management. This is achieved by giving the shareholders' power to

130 O Williamson, "Corporate Governance and Corporate Finance" (1988) 43 *J Fin* 567 at 572-3.

131 *Ibid* at 573-4.

132 See footnote 107 *supra* and accompanying text.

133 Compare with M Roe, "Chaos and Evolution in Law and Economics" (1996) 109 *Harv L Rev* 641 at 665-7.

134 O Williamson, note 130 *supra* at 571-2; O Williamson (1986) note 129 *supra*, pp 52-6.

135 O Williamson, note 130 *supra* at 579-581.

elect a board of directors, with (i) power to make decisions concerning appointing, remunerating and replacing management; (ii) rights of access to corporate information; and (iii) decision review powers regarding managerial matters.[136]

Given the earlier prediction that high-growth SMEs involve a high degree of asset specificity, Williamson's analysis emphasises the importance of ensuring that SME investors can exercise 'voice'. However, equity's effectiveness as a governance structure presupposes the efficiency of the board in safeguarding shareholder interests. 'Monitoring' boards of independent directors may be too expensive for small corporations; they may not be a *necessary* safeguard where shareholders are few in number and can negotiate directly, rather than by representation, with management. As shareholder numbers rise, collective action problems decrease the ability of shareholders to secure a collective good. Rising shareholder numbers may also decrease the representativeness of the board, because directors elected by shareholders themselves become agents needing to be monitored.

Other insights of TCE are also germane. TCE predicts that where specificity and uncertainty are high, and the parties transact frequently,[137] the most efficient governance structure is likely to unify the separate identities of transacting parties within a 'firm', so dissolving unstable market transactions.[138] The relationship between a minority equity investor and the management of an SME is unstable. The relationship becomes a 'bilaterally dependent' one: it depends on *both* parties, investor and management, acting consistently with the spirit of the exchange. Obviously, the investor is vulnerable to management opportunism, because of the clear opportunities for loss. However, in an SME, there are actions open to a shareholder that are opportunistic and which imperil the exchange. Most of these relate to legal action. In particular, the investor may try to invoke his or her rights under s 260 of the *Corporations Law*. Many exercises of managerial discretion may be impeached by the shareholder, perhaps on the grounds of being unfairly prejudicial to the member or contrary to the interests of the members as a whole. This is not to say that the shareholder would succeed, but the disruptive nature of the litigation and curial interference with corporate affairs may prove highly costly to the other shareholders of the corporation and the managers. The most 'final' sanction of s 260 is severe: liquidation.[139] Even lesser remedies can substantially impact on management.[140] The small shareholder, while bearing his or her own costs of a s 260 action, only internalises a small proportion of the costs of the corporation. Thus, the threat value of s 260 is considerable. It is a useful tactic for an opportunistic shareholder attempting to expropriate wealth from the corporation.

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136 *Ibid* at 580.

137 This condition is satisfied for investors in an SME, as equity investment is not only a long-term investment, in the sense that one must wait a good while for returns, but a perpetual 'administrative' relationship, given the legal nature of shares. As Williamson has pointed out, individual shareholders may be able to exit the corporation, but this is not so for shareholders collectively: O Williamson (1986), note 129 *supra*, p 304.

138 *Ibid*, pp 72-80.

139 See also ss 461(e), (f), (g) and (k).

140 Section 260(2)(d), (j), (k). For examples of the jurisdiction, *Re Spargos Mining NL* (1990) 8 ACLC 1218.

The proposed statutory derivative action provisions will operate similarly.[141] These provisions increase the ability of a shareholder to bring action against a director for negligence or fiduciary breach. While being granted leave to bring action is subject to a good faith requirement,[142] the disruptive value remains high. The provisions also confer an extensive jurisdiction on a court to interfere with the power of shareholders to quash any such action: any ratification of the impugned acts has, in effect, as much importance as a court decides it should have.[143] Finally, the disruption of management is increased by the ability of a court to compel the disclosure of information to the plaintiff for the purpose of the proceedings.[144]

Given these significant bilateral dependencies and the scope for opportunism by minority shareholders as well as management, this section and the earlier analysis of collective action problems suggest similar conclusions: the ability to exercise voice must not be obstructed by legal rules and institutions; fewer and larger shareholdings are desirable, and long term adaptability will often be enhanced by removing the investment relationship into a more stable, perhaps unified, governance structure.

C. The Task Force: Financing Growth by Black Letter Law

Given the above economic analysis, what can we say about the proposed changes to regulating SME fundraising? In its proposals,[145] the Simplification Task Force acknowledges the importance of encouraging small business. However, the proposed, reformed exemptions are strikingly unsuitable. If it is possible to make 20 offers a year, the number of minority shareholders can increase by 20 per year. For each extra shareholder, the ability of any one, or the group collectively, to exercise 'voice' in corporate governance decreases. The co-ordination and representation of shareholder interests at board level becomes more difficult and is affected by agency costs. As it is probable that no shareholder acting individually in such a corporation will have a sufficiently large interest to provide the collective good of controlling management, its provision depends on costly co-operative negotiation between larger shareholders. Such arrangements are susceptible to strategic behaviour. If arrangements of this sort do not succeed, the monitoring is likely to be inadequate.

The obvious problem with the 'gold-card' exemption is that it adopts a dollar figure which falls into the financing gap identified in the Council's report.[146] Secondly, while exempting 'large' investments is sound because size decreases collective action problems and may signify ability to fend for oneself in seeking information, it would be preferable to specify the threshold in terms of a proportion of voting shares. This signifies that collective action is a relative rather

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141 Commonwealth Attorney-General, *Proceedings on Behalf of a Company (Statutory Derivative Action) Draft Provisions and Commentary*, September 1995.

142 Proposed s 245B(2)(b).

143 Proposed s 245D.

144 See proposed s 245F(1)(d).

145 See text accompanying footnotes 10-12 *supra*.

146 See text accompanying footnote 21 *supra*.

than absolute concept. Arriving at an acceptable *minimum* figure may be challenging.[147]

Combining 'gold card' and 'personal' exemptions produces possibly quirky effects. The former encourages large shareholdings; the latter encourages small shareholdings. In groups where there is a significant difference between the size of interests, small members have an ability to exploit the large, in providing the collective good.[148] A further possibility of this occurring was noted in the above examination of opportunistic litigation by minorities.[149]

Finally, the Task Force proposal does nothing to assure that members can obtain information necessary to monitor and to exercise 'voice' in circumstances where asymmetries are pervasive. It seems strange that despite knowing little of the capital formation process, disclosure is mandated in fundraising situations, but, despite obvious governance problems, the parties are left to negotiate arrangements for monitoring and 'voice'.

D. The Government: Financing Growth By Deregulating It

Is the Government's advocacy of broader exemptions for SMEs a preferable one? It is clear from the Council's report that the capital raising process is expensive. The *Corporations Law* regime probably exacerbates this considerably with its mandatory due diligence requirement. At what price can a lower cost system be purchased?

Laissez-faire for SME fundraising is perilous because of pervasive conditions of information asymmetry and moral hazard. This is not mere theory or supposition. Professor Seligman has demonstrated a disproportionately large incidence of securities abuses in connection with fundraising and corporate management in smaller corporations partially or completely exempt from the mandatory disclosure and fundraising provisions.[150] Given that underwriters are not associated with SME issues, the absence from the capital formation process of an independent expert, or even an affiliated 'repeat player' with strong reputational capital to be protected (such as a career manager), exposes investors to a higher likelihood of fraud.

A 'hands-off' approach in a case of market failure is not an adequate solution. Apart from ignoring information asymmetry, broad exemptions do nothing to ensure the stability of the governance arrangements adopted by management and investors in SMEs.

E. A New Proposal

This part attempts a reconciliation of safeguarding 'voice' and providing a fundraising proposal with sufficient flexibility for what little we know about

147 In particular, it will be contingent on the proportional size of other interests: see text accompanying footnotes 124-5 *supra*.

148 M Olson, note 120 *supra*, p 35.

149 See text accompanying footnotes 140-5 *supra*.

150 J Seligman, "The Historical Need for a Mandatory Corporate Disclosure System" (1983) 8 *J Corp L* 1 at 33-6, 57-60.

capital formation in SMEs. The proposal proceeds from the premise that an optimal approach to SME financing requires a new conception of information entitlements that fulfils the ongoing information needs of investors, not just their needs at the outset of the venture.

A first important question is whether due diligence should be mandatory? The Council's report documents our ignorance of how investors, especially 'business angels', make investment decisions. We do not know what information is required, how it is provided, or how imperfect information is traded off for governance arrangements or pricing. Without understanding these dynamics, mandating the process by which information is provided, and equating the process with that employed when larger corporations raise capital, is likely to be misspecified. In many cases, a prospectus for a SME may be of limited use, because information that can be verified and expressed objectively may be less important than other forms of information. If it is unclear what should go into a prospectus, a regime which imposes *in terrorem* liability for omissions seems to have the potential for significant mistakes. Likewise, if it is unclear how prospectus information is supplemented and qualified by other information, it will be difficult to conclude that the prospectus misstates something. It follows that if a due diligence requirement is imposed through a rule that makes it a precondition of a defence to an action for omission or misstatement, it too will be misspecified and inefficient.

For these reasons, I do not favour a general due diligence requirement for SME investment. Knowledge of the subject being regulated is a precondition of effective regulation. The proposal is therefore to allow the investor and the corporation (through management) to decide the means for supplying, processing and verifying information. Given that the proposal in this section seeks to encourage SMEs to have fewer, larger shareholdings, we can have more confidence in the parties making optimal decisions in this respect. Because the investor is acquiring a larger interest, the investor has stronger incentives to make optimal decisions regarding the cost of acquiring and processing information, just as a bidder looks very carefully at a target corporation before making a takeover. Note also that a prospectus document has stronger claims where the number of potential investors is larger, as it economises on the cost of negotiating what information is required, and the costs of producing and disseminating information. Since this proposal prefers a small number of investors in SMEs, these claims are weaker, so we can feel more confident about deregulating the disclosure process.

It remains important to retain a rule that prohibits fraudulent disclosures or omissions. Contraventions of that rule should be punishable by *in terrorem* liability directed to the person responsible for or who knew of (and acquiesced in) the fraud.[151] This anti-fraud rule would apply to any part of the negotiations concerning investment in the corporation during which information was exchanged. Consistently with the development of the 'fraud-on-the-market' doctrine in the United States (which applies to alleged breaches of the anti-fraud

151 See text accompanying footnotes 109-110 *supra*.

provision, rule 10b-5),[152] the plaintiff would not have to prove reliance as a pre-condition of a cause of action.[153] This facilitates the bringing of actions, and increases the deterrence of fraud.

The rules above do not prevent the distortion of shareholders' incentives to provide the collective good of monitoring management and exercising voice; they also do not encourage the evolution of stable contracting equilibria. How can this be done? We have noted that *ceteris paribus*, larger shareholdings and fewer shareholders are desirable, and that contracting in respect of highly specific assets across a market interface and an environment of uncertainty is potentially an unstable contracting mode. It may eventually give way to a unified form of governance; if it does not, special forms of ongoing governance are likely to be needed.

Given these premises, the development of SME investments may be encouraged if they are financed and monitored by larger corporations active in similar lines of business. The large corporation could hold a majority equity interest. Alternatively, it could acquire all of the equity. The latter route is a means by which financing ceases to be a market transaction, and becomes an issue for internal cash flow management. This logic resembles traditional TCE research issues regarding the vertical integration of a stage of production.[154]

There are several reasons for such a proposal. Firstly, there may be economies of scope and scale in unifying the productive enterprises of large and small corporations. Secondly, by virtue of experience in, and specialised management practices for, the relevant industry, the large corporation is likely to be a more efficient monitor of management of the smaller corporation than other investors. Thirdly, collective action problems are decreased by majority stakes. These second and third points imply that the optimal amount of monitoring will be provided by a person likely to do so most efficiently. Fourthly, the resources of a corporation may permit the development of the SME's growth assets in a way that the insolvent trading regime under the *Corporations Law* would not permit if the SME was an autonomous entity.[155] The Council's report noted that the negative cash flow position of many SMEs could create problems with the insolvent trading

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152 (1995) 17 CFR § 240.10b-5. The rule states:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

a) To employ any device, scheme, or artifice to defraud,

b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

153 See *Basic Inc v Levinson* (1987) 485 US 224 at 247. For an analysis of the economic justifications for eliminating reliance as an element of an anti-fraud action, see N Georgakopoulos, "Frauds, Markets, and Fraud-on-the-Market: The Tortured Transition of Justifiable Reliance from Deceit to Securities Fraud" (1995) 49 *U Miami L Rev* 671.

154 See O Williamson (1986), note 129 *supra*, pp 85-130.

155 *Corporations Law*, ss 588G-Z. Note ss 588V-X, regarding holding company liability.

regime, as debts would often be incurred at a time of doubtful solvency.[156] If, however, the holding company funds losses and guarantees debts, there is no problem. More generally, insolvency is perilous to assets of high specificity because they cannot be easily redeployed. A large corporation providing finance has an interest to prevent such deadweight losses that a market does not have. Fifthly, if the SME becomes wholly owned, there are tax advantages from tax loss grouping.[157] Finally, and most importantly, the proposal accords with TCE's prediction of the superior stability of unified governance for highly specific assets developed over the long term in uncertain environments.

I envisage this as *one* means of moving towards an ideal of larger shareholders and better governance. This proposal follows logically from the premises of TCE and collective action theory, and should be considered for possible facilitation within the legislative regime. A problem is that a majority position may be too much to give up for the needed finance. There are also inevitable anti-competitive aspects to this approach, and it entails the inevitable decay of stronger incentives when one moves from market to firm.[158] The remainder of the proposal considers other means of moving towards the ideal.

It is important to preserve substantial fundraising exemptions in situations where reasonably large minority interests are held. Optimising this figure is ultimately a matter of selecting a level where collective action problems are manageable. Decreasing collective action problems may be achieved by decreasing the cost to shareholders in taking action for the collective good. Therefore, an exemption from the prospectus regime would be conditional on shareholders having entitlements that facilitate monitoring, such as a right to convene, attend and speak at board meetings, and a right to inspect corporate documents, unless acting in bad faith. This increases shareholders' ability to act for the collective good of the corporation. It also increases the amount of monitoring, by decreasing the cost to do so. Further, it facilitates ongoing sequential decision making, decreases information asymmetries, and may add to a climate of openness and trust. By having some form of minimum shareholding for the fundraising exemption to apply, the possibility of these rights being exploited by small shareholders is lower because shareholders internalise a larger proportion of the costs of opportunistic behaviour. Establishing an optimal threshold is a matter of both economics and judgment.

Expanding the shareholders' information rights indirectly deters fraud at the initial disclosure stage preceding investment. A shareholder who can inspect corporate documents may be able to determine at a low cost whether some disclosures that were, or were not made, were fraudulent. The higher the probability of discovering a fraud, the lower is the inclination to commit it.

This clear preference for a small number of investors also has a basis in the Coase theorem. [159] This theorem states that the smaller the number who must negotiate inter se, the lower the transaction costs will be and the lower the

156 National Investment Council, note 12 *supra* at 38-9.

157 *Income Tax Assessment Act* 1936 (Cth), s 80G.

158 O Williamson (1986), note 129 *supra*, pp 137-47.

159 R Coase, "The Problem of Social Cost" (1960) 3 *J Law & Econ* 1.

transaction costs, the more likely it is for shareholders to structure optimal arrangements.

F. The Implications of Corporate Law for the Proposal

How might a corporate law regime facilitate these proposals? I have already mentioned that exemptions from the fundraising regime should be conditional on offers in excess of a threshold, where shareholders have greater-than-normal information entitlements. Encouraging large corporations to become the financiers and monitors of SMEs is difficult to achieve directly through a corporate law model and may need a variety of measures at the industry level.

There are aspects of the present law regarding corporations which discourage these proposals, and therefore prevent efficient equilibria from being reached. Changes to these aspects of the law are desirable. Briefly, desirable changes include the following:

The takeover regime: Unless a corporation has less than 15 shareholders,[160] a shareholder (such as a large corporation investor) making a takeover must comply with the provisions in Chapter Six of the Law. The takeover regime increases the cost of a takeover and therefore decreases the likelihood that one will be made.[161] Large corporations may not acquire a 100 per cent stake initially; if they do not, the takeover regime will discourage increasing the stake. This is undesirable. The takeover provides other investors with an exit option. The elimination of smaller stakes and the increase of larger ones will eliminate collective action problems.

Compulsory acquisition: After the retrograde development of *Gambotto v WCP Ltd*,[162] the compulsory acquisition of minority shareholdings has been greatly confused.[163] The recent report by the Companies & Securities Advisory Committee proposes steps in the right direction.[164] These will be desirable for the same reasons as those described in the preceding paragraph.

Directors' duties: In general, the duties of directors of entities making up a corporate group are dominated by *Walker v Wimborne*.[165] In this case the High Court rejected the welfare of a corporate group as a consideration relevant to the exercise of a directors' duties. While there are signs that this principle has some flexibility,[166] there needs to be an explicit recognition that directors appointed by a holding company are entitled to act in a way that is in the interests of a corporate

160 *Corporations Law*, s 619.

161 See generally D Fischel, "Efficient Capital Market Theory, the Market for Corporate Control and the Regulation of Cash Tender Offers" (1978) 57 *Tex L Rev* 1.

162 (1995) 182 CLR 432.

163 See P Spender, "Compulsory Acquisition of Minority Shareholdings" (1993) 11 *C & S LJ* 83; D Grave, "Compulsory Share Acquisitions: Practical and Policy Considerations" in I Ramsay (ed), *Gambotto v WCP Ltd: Its Implications for Corporate Regulation*, Centre for Corporate Law and Securities Regulation (1996) at 14.

164 Legal Committee of the Companies & Securities Advisory Committee, *Compulsory Acquisitions Report*, AGPS, 1995.

165 (1976) 137 CLR 1 at 6-7.

166 See *Equiticorp Financial Services Ltd v Equiticorp Financial Services Ltd (NZ)* (1993) 11 ACLC 84; *ASC v Matthews* (1995) 16 ACSR 313 (taking a more balanced approach to the merits of intra-group transactions in s 232(6) cases); and R Austin, "Problems for Directors within Corporate Groups" in M Gillooly (ed), *The Law Relating to Corporate Groups* Federation Press (1993) at 142.

group.[167] This principle should extend to any person who nominates a director to the board. By parity of reasoning, s 60(1)(b) which deems persons who direct or instruct the corporation's directors to be directors themselves, needs reconsideration. The above analysis shows that it is imperative to facilitate the expression of 'voice' by shareholders in SMEs in the absence of a liquid or efficient secondary market for the corporation's securities. We saw that collective goods (such as monitoring and the expression of 'voice' in managerial matters) are often provided for a group because one of the members regards the provision of the collective good as being sufficiently beneficial for herself.[168] A legal regime is misconceived if it provides disincentives to this process by subjecting the active shareholder to director liabilities.

V. CONCLUSION

The above proposal is doubtless open to criticism on various grounds, the formulation of which I leave to the reader. Many may criticise the advocacy of large corporation investors as being inconsistent with the notion of developing an enterprising SME sector. However, society benefits if profitable business opportunities are developed; if the development of the opportunities of high-growth SMEs can occur through the involvement of larger corporations, as the analysis suggests, the law should not discourage this result. The proposal leaves it to SMEs to initiate innovative and enterprising investments, and seeks the most efficient institutions to develop these investments.[169]

Whatever my proposal's faults, the solutions regulators have offered so far to improve capital formation in worthy SME enterprises have profound flaws. They fail to give proper attention to underlying problems in SMEs. They also fail to take an objective view of the purposes of the prospectus regime, its success in accomplishing those purposes, and the suitability of alternative means to do so.

The benefits of the current prospectus regime, the centrepiece of which is the connection between the mandatory due diligence defence and *in terrorem* liability for misstatement and omission, are far from clear. Empirical evidence is needed to assess these benefits. This article has employed theoretical economics to analyse what these benefits might be; also considered were the implications and limitations of accumulated empirical evidence to test for the existence of these benefits. When one engrafts such a system (in which the benefits are unclear even for the largest, and most visible corporations) onto a SME context, the uncertainty becomes acute.

Reform choices for SMEs must reconcile three competing issues of information. Firstly, we know little about how decisions are made regarding investment in

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167 This principle would be subject to determining the appropriate level of protection, if any, for creditors prejudiced by group-motived transactions. See M Byrne, "An Economic Analysis of Directors' Duties in Favour of Creditors" (1994) 4 *Aust J Corp Law* 275 (arguing such protections are inefficient and unnecessary).

168 See text accompanying footnote 122 *supra*.

169 Compare with M Chesterman, *Small Businesses*, Sweet & Maxwell (1977) p 34.

SMEs. Secondly, theory suggests that sub-optimal information will be produced regarding SMEs, as the incentive to do so profitably is limited, and that this will systematically disadvantage investors. Combined with a lack of market discipline, this leads to pervasive information asymmetries, as documented in the National Investment Council report. Thirdly, the crucial issue in growth SMEs is ensuring investors have access to ongoing information. Concentrating on pre-investment activities is only part of the problem. The supply of information to the investor afterwards is perhaps even more important, because of the long-term character of the relationship, the lack of an 'exit' option and the serious agency problems that seem to exist. Because contracting in respect of assets of high specificity under conditions of limited information and opportunism is the subject of TCE, I have adopted solutions that follow from its analysis. These solutions are twofold. Firstly, the proposal limits the number of investors in order to reduce collective action problems. Limiting the number of investors also facilitates and lowers the cost of face-to-face bargaining between the investors and managers. This solution accords with the Coase theorem.[170]

The second part of the solution emphasises mechanisms that lead to information entitlements in a world where information will be underproduced. Underproduction of information leads to the obvious 'lemons' problem described in Coffee's quote.[171] The lemons problem will cause many profitable business opportunities to lapse, and will lead to too many rogues 'hawking' worthless securities. This problem might be solved by a majority investor with established management expertise in the area; it can be solved by expanded shareholder rights to information, either de jure for minority shareholders or de facto for majority shareholders, and the resolution of modern corporate law anomalies. These solutions do not adopt a 'mandatory' disclosure approach, because of both its high costs and the unknown dynamics of conveying information in SMEs. Protection against fraud however, remains a component of the regime.

The proposal uses an alternative means of accomplishing the two motivations of the mandatory due diligence regime. These motivations were to reduce information analysis cost and increase efficient capital allocation through decreased information asymmetry. These can be achieved *without* mandatory due diligence, by conditioning exemptions on small numbers of investors. A smaller number of investors allows information costs to be kept low without adopting a mandatory procedure. Decreased information asymmetry is achieved through a partially self-enforcing rule against opportunism and expanding the information rights of shareholders.

The purpose of this paper is thus both critical and constructive. It is necessary to examine the merits of the present system, and criticise the solutions so far advanced as unsuitable and incomplete. The paper is constructive because it advances a new proposal for SME financing, with some basis in institutional economics. A 'Hamletesque' caution is therefore warranted for both Task Force

170 R Coase, note 159 *supra.*

171 See text accompanying footnote 107 *supra.*

and Government: "There are more things in Heaven and Earth, Horatio, [t]han are dreamt of in your philosophy".[172]

172 W Shakespeare, *Hamlet*, Act I, scene v.