RECENTLY OVERHAULED DISCLOSURE PHILOSOPHY FOR PUBLIC ISSUES OF SECURITIES IN AUSTRALIA: A WAKE-UP CALL FOR THOSE WHO ARE STILL ASLEEP

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ABSTRACT

The disclosure-based regulation (DBR) has been the most dominant regulatory philosophy for primary securities markets worldwide for decades. The philosophy is based on a 'myth'—that corporations aspiring to raise funds from the market will fully disclose the "whole truth" to the investing public. The assumption is that the public, despite a significant lack of financial literacy among the majority, will properly analyze and utilize the disclosed complex financial information in making their investment decisions. This unreasonable expectation has proven to be a myth rather than a reality during the last global financial crisis (GFC). Many economists predict that the next man-made GFC is not far away. Australia has recently modified its disclosure regime in a quest for a better consumer outcome based on consecutive two financial system inquiry reports and corresponding recommendations of its national law reform commission. The modifications depart from the original DBR by imposing new, specific designs and distribution obligations on both securities issuers and their distributors aimed at protecting retail investors. This Article critically examines the usefulness of the DBR for individual unsophisticated investors and finds that those financial consumers are generally unable to understand corporate fundraising disclosures owing to various reasons, including a lack of adequate investment knowledge, defects in disclosures, and cognitive and behavioral biases. Drawing on its findings, this Article submits a set of recommendations with justifications embracing the recent reforms made in Australia, a developed economy, and solicits widening the scope of the proposed reforms crossing the boundary of newly introduced Australian paternalistic regulation (especially for developing and least developed countries). The central recommendation is to introduce a hybrid policy of disclosure and merit regulation to invigorate investor protection.

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I. INTRODUCTION

Securities markets are where both gains and losses are always hidden and uncertain. This is likely why Princeton Professor Burton Malkiel comments that "[b]asically, the security analyst must be a prophet without the benefit of divine inspiration".[1] This uncertainty exists in both the primary and secondary markets. The former is popularly called the market for initial public offerings (IPOs) or the IPO market.[2] This unpredictability and precariousness are worsened by the culpability of corporations and gullibility of investors[3] in which the former attempts to take advantage of the latter. The advantage taken rests on the material

[1] Securities analysis requires prophetic knowledge without divine blessings. *See* BURTON G. MALKIEL, A RANDOM WALK DOWN WALL STREET 121 (1990).
[2] For details about IPO markets, *see* SHEIKH M. SOLAIMAN, INVESTOR PROTECTION IN A DISCLOSURE REGIME: AN INTERNATIONAL AND COMPARATIVE PERSPECTIVE ON INITIAL PUBLIC OFFERINGS IN THE BANGLADESH SECURITIES MARKET (2003) (Ph.D. thesis, University of Wollongong) (on file with the University of Wollongong Thesis Collection).
[3] LOUIS LOSS, FUNDAMENTALS OF SECURITIES REGULATION 1 (2d ed. 1988).

information belonged to and possessed by issuers of securities and is typically unknown to potential investors or subscribers to their IPOs. Thus, a critical informational asymmetry exists between issuers and potential investors.[4] This asymmetry warrants regulation of corporate fundraising conduct for investor protection, which has prompted creation of two major philosophies for such regulation: merit-based regulation (MBR, or merit regulation) and disclosure-based regulation (DBR or disclosure philosophy, or disclosure regulation). The MBR was the effective tool of protecting investors in IPO markets globally until the adoption of the disclosure philosophy by the U.S. following the devastating market crash in 1929.[5] This triggered the adoption of the DBR by the U.S. at a federal level and thereby effectively popularized the philosophy. This approach has been gradually adopted by other nations, regardless of their market development level and without any study conducted on their specific market readiness to adapt this regulation. The International Organization of Securities Commissions (IOSCO) argues in favor of substantive paternalistic regulation for underdeveloped markets. An assessment by this world body of securities regulators notes that the MBR, rather than the DBR, is a preferable regulatory philosophy for developing markets,[6] Nevertheless, it has assumed the reputation of being a dominant philosophy worldwide for developed and least developed economies alike.[7] The disclosure philosophy ignores the inability of the investing public to analyze and utilize the information being disclosed by issuers, and it incorrectly claims that the DBR enables investors to make informed investment decisions which require prophetic knowledge and skills in assessing merits in IPOs of securities.[8] The disclosure philosophy is supported by the concept of extreme free-market economy, although it has been proven[9] that the "invisible hands" of the market ‒as termed by Adam Smith, a pioneering free-market economist [10]‒ is utterly unable to protect retail investors.[11] Even

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[4] Bernard S. Black, *The Legal and Institutional Preconditions for Strong Securities Markets,* 48 UCLA L. REV. 781, 786 (2001).

[5] For details about this crash, *see generally* BERNARD C. BEAUDREAU, THE STOCK MARKET BOOM AND CRASH OF 1929 WAS NOT A BUBBLE (2019).

[6] INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, OBJECTIVES AND PRINCIPLES OF SECURITIES REGULATION 24 (2003), https://www.iosco.org/library/pubdocs/pdf/IOSCOPD154.pdf [hereinafter IOSCO].

[7] *See* Michael D. Guttentag, *Evolutionary Analysis in Law: On Disclosure Regulation*, 48 ARIZ. ST. L. J. 963, 972 (2017); Wendy Gerwick Couture, *A Glass-Half-Empty Approach to Securities Regulation* 76 MD. L. REV. 360, 371 (2017).

[8] Malkiel, *supra* note 1.

[9] *See* Sheikh. M. Solaiman, *Revisiting Securities Regulation in the Aftermath of the Global Financial Crisis: Disclosure – Panacea or Pandora's Box?*, 14 J. WORLD INVEST. & TRADE 646 (2013).

[10] *See generally*, ADAM SMITH, THE WEALTH OF NATIONS (1776).

[11] *See generally* Susanna Kim Ripken, *Paternalism and Securities Regulation*, 21 STAN. J.L. BUS. & FIN. 1 (2015); Susanna Kim Ripken, *The Dangers and Drawbacks of the Disclosure Antidote: Toward a More Substantive Approach to Securities Regulation*, 58 BAYLOR L. REV. 139 (2006); SOLAIMAN, *supra* note 9.

institutional and sophisticated investors are not immune from the financial dishonesty, greed, and mischief of securities issuers.[12] Despite the huge disputes against the adoption of the DBR in its introduction in the U.S., the philosophy has impregnated the modern notions of securities regulation globally.[13] The inherent driving forces of this regulatory tool which make it very popular is arguably that it relieves the regulator from any responsibility to assess the merits of IPOs that could be relied upon by investors, especially retailers. Such a relief incentivizes issuers to float and exploit gullible investors knowing that the fund providers are unable to properly determine the merits or demerits of their offers. This is because the DBR allows companies to raise funds from the public regardless of their actual financial health and future potentials to perform well. The unfairness in this game between two unequal players (issuers and investors) in IPO markets is gradually felt deeply by both investors and regulators alike, insisting on some watchdogs to take measures to minimize and redress this lopsided opportunity.[14] In support of the DBR, the United States Supreme Court (U.S. Supreme Court) in *Basic Inc. v. Levinson* observed that "a 'fundamental purpose' of the various securities acts, 'was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry.'[15] However, this professed high standard is yet to be achieved in the U.S., as is evident from the occurrence of the GFC, enactment of the *Sarbanes-Oxley Act of 2002* (U.S.),[16] the *Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010,*[17] etc.

The time is ripe to admit that the disclosure philosophy is not a panacea,[18] as its proponents who drafted the U.S. federal securities laws may have anticipated to be. The DBR itself cannot prevent market failures or protect investors unless the financiers protect themselves by carefully reading the disclosure documents and

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12 For details, *see generally* Philipp M. Hildebrand, *The Sub-prime Crisis: A Central Banker's Perspective*, 4 J. FIN. STABILITY 313 (2008).

13 Couture, *supra* note 7, at 371.

14 For example, Australia has modified the application of the DBR as will discussed later in this Article.

15 Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) (quoting SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963)). Also *see* Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023, 1023 (2000).

16 *See generally* Ujkan Q. Bajra et al., *The Impact of the Sarbanes–Oxley Act on the Integrity of Financial Reporting: Was It Meritorious*, 34 J. CORP. ACCT. & FIN.184 (2023).

17 *See generally* PETER J. WALLISON, BAD HISTORY, WORSE POLICY: HOW A FALSE NARRATIVE ABOUT THE FINANCIAL CRISIS LED TO THE DODD-FRANK ACT (2013).

18 Solaiman, *supra* note 9. Also *see generally* Sheikh M. Solaiman, *Adoption of the Disclosure-Based Regulation for Investor Protection in the Primary Share Market in Bangladesh: Putting the Cart before the Horse?*, 1 CORP. GOV. L. REV. 115 (2005); Sheikh M. Solaiman, *Disclosure Philosophy for Investor Protection in Securities Markets: Does One Size Fit All?,* 28 COMP. LAWYER 135 (2007).

properly assessing them before making their investment decisions.[19] The inability of investors to meaningfully perform their parts of appraising the merits of a public offer makes the regulatory philosophy a failure, as will be argued in this article.

As part of recognition based on credible research, Australia has enacted a statute titled, the *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (DDOs & PIPs Act 2019) which imposes specific obligations on issuers to design and distribute their securities targeted to be issued to retail investors. The DDOs & PIPs Act 2019 came into force on October 5, 2021.[20] This legislation is a product of the Financial System Inquiry Final Report, 2014 (FSIR 2014 or the Murray Inquiry), which was built on the previous report: the Financial System Inquiry Final Report, 1997 (FSIR 1997, the Wallis Inquiry). In 2013, the Australian Government, also referred to as the federal government or Commonwealth government, appointed the latest Financial System Inquiry Committee. The Committee was chaired by Mr David Murray and "charged with examining how the financial system could be positioned to best meet Australia's evolving needs and support Australia's economic growth."[21] The Committee submitted its final report in November 2014, which included recommendations for the introduction of design, distribution obligations (DDOs), and product intervention powers (PIPs)[22] that have been implemented by the DDOs & PIPs Act 2019.

The DDOs & PIPs Act 2019 introduced a regulatory tool representing a synthesis of disclosure and merit-review philosophies. The comprehensive investigations into the Australian financial systems incorporated into the FSIR 2014 has forewarned that their proposed new reform in the heavy reliance on the disclosure philosophy "would deliver benefits to industry, including strengthening internal risk management for product design, which may mitigate future problems, as well as signalling a higher level of customer focus."[23] The FSIR 2014 also

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19 *See generally* Steven M. Davidoff & Claire A. Hill, *Limits of Disclosure*, 36 SEATTLE U. L. REV. 599 (2013).

20 PwC, PRODUCT DESIGN AND DISTRIBUTION OBLIGATIONS 2020 REGULATORY GUIDE 274 (2020), https://www.pwc.com.au/industry/financial-services/assets/publications/pwc-design-distribution-obligations-insights-dec20.pdf. See also ASIC, Product Design and Distribution Obligations, Regulatory Guide 274 (2020) (RG 274), (Austl.) https://download.asic.gov.au/media/dlpccdof/rg274-published-11-december-2020-20220628.pdf.

21 THE TREASURY, AUSTRALIAN GOVERNMENT, FINANCIAL SYSTEM INQUIRY–TERMS OF REFERENCE (2014), https://treasury.gov.au/consultation/c2014-fsi-tor. This source also includes the terms of reference of the Committee.

22 *See* Recommendation 21: Strengthen product issuer and distributor accountability and Recommendation 22: Introduce product intervention power of the FSIR 2014.

23 THE TREASURY, AUSTRALIAN GOVERNMENT, FINANCIAL SYSTEM INQUIRY FINAL REPORT 203 (2014), https://treasury.gov.au/sites/default/files/2019-03/p2014-FSI-01Final-Report.pdf [hereinafter FSI Final Report 2014].

mentions that the proposed reforms will promote efficiency in the overall financial system of the nation.[24]

The Article offers lessons that can inform potential law reforms in countries which are still heavily reliant on the disclosure philosophy for investor protection in their securities markets. This Article proceeds as follows: following this introduction in Part I, Part II discusses the emergence of the disclosure philosophy in the United States (U.S.) and its suitability for the developing securities markets; Part III analyzes the disclosure regulation as the key regulatory philosophy; Part IV critically scrutinizes the suitability of the disclosure regulation to protect securities investors with an emphasis on retailers; Part V introduces the design and distribution obligations in Australia which has been added to the corporations legislation, partially departing from the disclosure philosophy in 2019 with effect from October 2021; Part VI presents various aspects of the critical regulatory powers for product intervention by regulator conferred in 2019 and effective from October 2021, along with a response to the critics of these powers in favour of retail investors; and Part VII concludes this endeavor with its findings and recommendations.

II. The Emergence of the Disclosure Philosophy in the United States and Its Suitability for Developing Markets

"Disclosure," in simple terms in the present context, refers to a set of information that must be provided as mandated by law to potential investors by the fundraising corporations including material information regarding the characteristics, fees, and/or risks of the underlying financial products enabling investors to make informed investment decisions.[25] Until the enactment of the *Securities Act of 1933* (U.S.), securities had only been regulated in the U.S. at the state level under the "blue sky law," which was first enacted in 1911 in the State of Kansas[26] to protect investments and thereby investors under the MBR.[27] Kansas legislators were inspired by Joseph Norman Dolley, the state bank commissioner of the day, to introduce the blue sky legislation, which served as a model law for other states, prompting 47 U.S. states to legislate similar pieces of legislation between 1911 and 1933 until the advent of the federal securities regulation.[28] Regarding the purposes of the law, the U.S. Supreme Court declared in *Hall v Gieger-Jones Co*

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[24] *Id*.

[25] *See* AUSTRALIAN SECURITIES AND INVESTMENTS COMMISSION & DUTCH AUTHORITY FOR THE FINANCIAL MARKETS, DISCLOSURE: WHY IT SHOULDN'T BE THE DEFAULT 3 (2019), https://download.asic.gov.au/media/5303322/rep632-published-14-october-2019.pdf [hereinafter ASIC and Dutch Authority, 2019].

[26] LOSS, *supra* note 3, at 8.

[27] KANSAS HISTORICAL SOCIETY, KANSAS BLUE SKY LAWS (2015), https://www.kshs.org/kansapedia/kansas-blue-sky-laws/18618.

[28] *Id*.

that the State '"Blue Sky Laws' aimed to regulate 'speculative schemes which have no more basis than so many feet of blue sky."[29] The Court also added that states legislated the blue sky laws to protect investors from unscrupulous promoters who would engage with selling shares in the blue sky itself.[30] The states' merit regulation under the blue sky laws protected investors from buying securities judged to be very risky by their respective state regulators who did not approve those proposed public offers.[31] Hence, the significance of the term "blue sky" lies in the objective of the legislation that they were adopted to regulate baseless and broad speculative investment schemes in their respective states.[32] This is how the regulators acted as a true gatekeeper. There are still 27 states in the U.S. which follow merit regulation.[33]

The MBR adopts a paternalistic approach to regulation intending to make investors "better off" compared to allowing them to make their own investment decisions by assessing the merits of a particular offer themselves.[34] This regulatory intervention can be likened to the situation of a person approaching a bridge without knowing that it would be dangerous to cross the bridge, but a reasonable bystander or onlooker who personally knows about the risk the passer-by was taking (without knowledge about the danger), would be justified to paternalistically prevent that person from proceeding towards the highly risky bridge.[35] This prevention may sound like "an act against the will of a person," but justification rests on the fact that he or she was unaware of the danger and that the person would not have ventured to cross the bridge had he or she known the risk.[36] Hence, the prevention was not an act against the person's true will. Further, accepting the truth in merit regulation that it is designed with an intention to promote public interests is not a form of degradation of potential investors.[37] John Stuart Mill argued in the same line, asserting that if a person voluntarily decides to sell himself/herself into slavery, that person shall be prevented from proceeding towards such a sale.[38] Paternalistic merit regulation adds value in generating and maintaining public

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[29] Hall v. Gieger-Jones Co., 242 U.S. 539, 550 (1917).

[30] *Id*.

[31] *See* Ronald J. Colombo, *Merit Regulation Via the Suitability Rules*, 12 J. INT'L BUS. & L. 1, 7-8 (2013); John S. (Jack) Wroldsen, *The Social Network and the Crowdfund Act: Zuckerberg, Saverin, and Venture Capitalists' Dilution of the Crowd,* 15 VAND. J. ENT. & TECH. L. 583, 607-608 (2013). *See generally* Conrad G. Goodkind, *Blue Sky Law: Is There Merit in the Merit Requirements?,* 1976 WIS. L. REV. 79 (1976).

[32] LEGAL INFORMATION INSTITUTE, BLUE SKY LAW (2021), https://www.law.cornell.edu/wex/blue_sky_law.

[33] Couture, *supra* note 7, at 374.

[34] Bill New, *Paternalism and Public Policy,* 15 ECON. & PHIL. 63, 66 (1999).

[35] *See* JOHN STUART MILL, ON LIBERTY 172-73 (2002). *See also* David L. Shapiro, *Courts, Legislatures, and Paternalism,* 74 VA. L. REV. 519, 525 (1988).

[36] *See* Jeremy A. Blumenthal, *Emotional Paternalism,* 35 FLA. ST. U. L. REV. 1, 7-8 (2007).

[37] *See* SARAH CONLY, AGAINST AUTONOMY 42 (2012); Gerald Dworkin, *Against Autonomy Response,* 40 J. MED. ETHICS 352, 353 (2014).

[38] Mill, *supra* note 35, at 184.

confidence in the market, and also helps to improve the emotional sense of well-being when the public knows that an overarching regulatory system is in place to protect them.[39]

The MBR proffers similar preventative services to uninformed investors with respect to pricing of securities offered. A study conducted by Professor Brandi on the effects of merit regulation of IPOs revealed that "[t]he issues complying with the least stringent merit regulations come to market with prices which require more market adjustment than those issues from strong merit states."[40] Securities price exaggeration harms subscribers. Several distinguished corporate law professors in the U.S., including Professor John Coffee and Professor Hillary Sale, support by stating in the public interest, a paternalistic approach should apply to the securities market in order to protect the investing public from making a flawed assessment leading to investment in a bad offer of securities.[41] Therefore, the demand for merit regulation of securities is well founded.

Further, paternalism in law is by no means an unexpected concept. Most of the prohibitions or requirements created by positive laws are largely paternalistic. For example, prohibitions on gambling for excessive amounts of money, driving after heavily drinking alcohol, not running red lights or speeding, etc. The rules of merit regulation aim to protect investors who can be foolish, ill-informed, short-sighted, imprudent, irrationally exuberant, manipulated by issuers and their brokers, and so on.[42] Therefore, the law of regulation is greatly about paternalism for public good, because the prohibition is put in place by imposing duty on people to prevent them from doing something what they are willing to do, or in some cases serious to do something which will consequently undermine public interest or others' rights. When paternalism is viewed from the legal context, it can be said that paternalistic approach involves making and enforcing specific rules that either proscribe or permit certain conduct to provide protection to people from harm as well as to promote their own good.[43] Professor Anthony Ogus expounds that the policy of legal paternalism is "one in which the law seeks to override individual choice on the ground that the individual or individuals in question might not

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[39] *See* Peter H. Huang, *How Do Securities Laws Influence Affect, Happiness, & Trust?*, 3 J. BUS. & TECH. L. 257, 297 (2008).

[40] Jay T. Brandi, *The Silver Lining in Blue Sky Laws: The Effects of Merit Regulation on Common Stock Returns and Market Efficiency,* 12 J. CORP. L. 713, 734 (1987).

[41] *See* John C. Coffee & Hillary A. Sale, *Redesigning the SEC: Does the Treasury Have a Better Idea?,* 95 VA. L. REV. 707, 727-28 (2009). *See also* Henry T.C. Hu, *Illiteracy and Intervention: Wholesale Derivatives, Retail Mutual Funds, and the Matter of Asset Class,* 84 GEO. L.J. 2319, 2378-79 (1996); Donald C. Langevoort, *The SEC, Retail Investors, and the Institutionalization of the Securities Markets,* 95 VA. L. REV. 1025, 1082-83 (2009).

[42] *See* Stephen J. Choi & A.C. Pritchard, *Behavior Economics and the SEC,* 56 STAN. L. REV. 1, 15 (2003); Oskari Juurikkala, *The Behavioral Paradox: Why Investor Irrationality Calls for Lighter and Simpler Financial Regulation,* 18 FORDHAM J. CORP. & FIN. L. 33, 44 (2012).

[43] Ripken, *supra* note 11, at 10.

exercise that choice wisely, with consequential harm to themselves."[44] Hence, it may be easy to oppose the MBR in theory, but it must be difficult to ignore its benefit in practice regarding the protection of investors and their investments, as the paternalistic rules exit in many other respects of our life.[45] All these justify adoption of merit regulation for IPOs. Nevertheless, mandatory disclosure has now been a key regulatory philosophy for the regulation of primary issues of securities.[46]

III. DISCLOSURE AS THE KEY REGULATORY PHILOSOPHY

Disclosure is an alternative to paternalistic substantiative regulation introduced in 1933 in the U.S.[47] As opposed to the more intrusive MBR,[48] the disclosure philosophy merely requires publication of material information in relation to underlying securities in preference to judging merits of an IPO for potential investors by the regulator.[49] The DBR obligates issuers to disclose only the existing material facts and does not entail the issuer to include any economic forecast in the disclosure document.[50] A benefit of the disclosure philosophy for issuers is that a company can go public, regardless of whether its fundamentals are too poor to invest, and its risks are too big to digest, as long as investors buy the offer knowingly or unknowingly, and the government watchdog enjoys an absolute relief of any responsibility for the worthlessness of the public offer.

Such a disclosure aims to enable the investing public to analyze the information so disclosed in order to determine potential risks and returns associated with the offer and then make optimal investment decisions at their own peril.[51] The regulator presupposes that "investors are given access to all material information, it is up to them to decide how to use the information and to accept the consequences

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[44] *See* Anthony Ogus, *The Paradoxes of Legal Paternalism and How to Resolve Them,* 30 LEGAL STUD. 61, 62 (2010); Heta Häyry, *Legal Paternalism and Legal Moralism: Devlin, Hart and Ten,* 5 RATIO JURIS. 191, 193 (1992).

[45] Cass R. Sunstein, *Legal Interference with Private Preferences,* 53 U. CHI. L. REV. 1129, 1141 (1986).

[46] John Armour et al., *Principles of Financial Regulation*, 80 MOD. L. REV. 1193, 1195 (2017).

[47] *See* THOMAS LEE HAZEN, THE LAW OF SECURITIES REGULATION 20 (6th ed. 2009); Paula J. Dalley, *The Use and Misuse of Disclosure as a Regulatory System,* 34 FLA. ST. U. L. REV. 1089, 1093 (2007).

[48] *See generally* Roberta S. Karmel, *Blue-Sky Merit Regulation: Benefit to Investors or Burden on Commerce?,* 53 BROOK. L. REV. 105 (1987); Jonathan R. Macey & Geoffrey P. Miller, *Origin of the Blue Sky Laws,* 70 TEX. L. REV. 347 (1991).

[49] Ripken, *supra* note 11, at 2.

[50] Arber v. Essex Wire Corp., 490 F.2d 414, 421 (6th Cir. 1974); Jon Jacobson, *The Unsettled Issue from Leidos, Inc. v. Indiana Public Retirement System: Should Item 303 Provide a Private Right of Action?* 54(2) IND. L. REV. 445, 462 (2021).

[51] Ripken, *supra* note 11, at 2.

of their investment choices."[52] This supposition ignores the fact that investors lack adequate investment knowledge, which is not something to be automatically gained without divine blessings and sincere efforts to achieve it.[53]

Any law must be effectively conducive to achieving its objectives. Likewise, disclosure laws must be designed and worded in a way that facilitates their purposes. The IOSCO sets forth three objectives of securities regulation, namely: (1) protecting investors; (2) ensuring that markets are fair, efficient and transparent; and (3) the reduction of systemic risk.[54] Both the second and third objectives are intrinsically and effectively embedded in the first one. Therefore, all three can be combined to one as the primary objective of securities regulation: providing protection to the investing public. Consistently, the U.S. federal securities laws frequently mention that the laws are made "in the public interest and for the protection of investors."[55] Likewise, the first avowed mission of the U.S. Securities and Exchange Commission (SEC) is "to protect investors."[56]

The history of the DBR dates back to the 19th century when the British *Companies Act, 1844* (UK)[57] incorporated disclosure requirements for IPOs.[58] That requirement was a supplement to merit regulation, rather than supplant. The subsequent legislation, titled the *Companies Act, 1862* (UK), provides details of prescriptive disclosure for public issues. Australian corporations' law is founded on this *Companies Act, 1862* (UK),[59] however, it has gradually built on this field of law. In doing so, Australia has followed the U.S.'s lead in some instances, including the adoption of the DBR.

As mentioned earlier, the 1929 collapse of the securities markets in the U.S. eventuated in the introduction of the disclosure philosophy., the brainchild of the country's Supreme Court Justice Louis D Brandeis,[60] and implemented by President Franklin Delano Roosevelt by pressing a divided Congress to legislate it.[61] Against the merit regulation system, President Roosevelt pronounced that "[o]f

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[52] HAROLD ARTHUR JOHN FORD, ET AL., FORD'S PRINCIPLES OF CORPORATIONS LAW 877 (9th ed. 1999).

[53] Malkiel, *supra* note 1.

[54] IOSCO, *supra* note 6, at 2.

[55] *See* U.S. SECURITIES AND EXCHANGE COMMISSIONS, SECURITIES EXCHANGE ACT OF 1934 §§ 10(a) - 10(c); 15 U.S.C. §§ 78j(a) - 78j(c) (2023), https://www.govinfo.gov/content/pkg/COMPS-1885/pdf/COMPS-1885.pdf.

[56] U.S. SECURITIES AND EXCHANGE COMMISSIONS, ABOUT THE SEC (2016), https://www.sec.gov/about.

[57] LEGISLATION.GOV.UK, COMPANIES ACT 1948 §417 - 423, https://www.legislation.gov.uk/ukpga/Geo6/11-12/38/contents/enacted.

[58] *Id*.

[59] FADY AOUN, ET AL., REDMOND'S CORPORATIONS AND FINANCIAL SERVICES LAW 866 (8th ed. 2023).

[60] LOUIS D. BRANDIES, OTHER PEOPLE'S MONEY AND HOW THE BANKERS USE IT 92 (1914); Jacobson, *supra* note 50, at 447.

[61] H.R. REP. NO. 73-85, at 1-2 (1933); Daniel J. Morrissey, *The Road Not Taken: Rethinking Securities Regulation and the Case for Federal Merit Review*, 44 U. Rich. L. Rev. 647, 679 (2010).

course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties they represent will earn profit".[62] In the aftermath of the market crash, President Roosevelt promised to introduce securities regulation at the federal level in his election campaign in 1932 to protect investors.[63] He brought the preventative benefits of the disclosure philosophy to public attention referring to the claim of Justice Brandeis that "[s]unlight is said to be the best of disinfectants; electric light the most efficient policeman."[64] He also added to his election speeches another argument of Justice Brandeis that "[p]ublicity is justly commended as a remedy for social and industrial diseases."[65] As suggested by Harvard Professor Louis Loss, one of the architects of core federal securities laws in the U.S.,[66] Justice Brandeis is regarded the "spiritual father" of the *Securities Act*, 1933 which contains the disclosure philosophy,[67] and is applicable to only public offerings by companies.[68] The *Securities Act, 1933* is focused expressly on investor protection in the primary market.[69] The term "publicity" and "sunlight" mentioned in the assertions of Justice Brandeis obviously refer to disclosure regulation. However, he recognized that "excessive sunlight can cause skin cancer."[70] Paradoxically, defying the claim of the proponents of the DBR that it has "prophylactic effects" on securities markets,[71] it has arguably caused cancer (GFC) instead of serving as the best disinfectant.[72] For any regulatory system to be useful, it must be suitable for achieving its objectives.

IV. SUITABILITY OF THE DISCLOSURE REGULATION FOR INVESTOR PROTECTION

Players are unequal in securities markets because the price of the financial products depends on the critical information underpinning a public offer. That

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62 U.S. Government, *supra* note 61, at 1-2.

63 Guttentag, *supra* note 7, at 975.

64 Brandeis, *supra* note 60, at 92; Jacobson, *supra* note 50, at 447; Guttentag, *supra* note 7, at 975.

65 Brandeis, *supra* note 60, at 92. *See also* Joel Seligman, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND MODERN CORPORATE FINANCE 41-42 (1982). Louis Brandeis first published these assertions in 1913 in the *Harper's Weekly* article titled *What Publicity Can Do*. *See* Randy Lee, *Louis Brandeis's Vision of Light and Justice as Articulated on the Side of a Coffee Mug*, 33 TOURO L. REV. 323, 327 (2017).

66 *See* Richard W. Jennings, *Book Reviews*, 50 CALIF. L. REV. 365, 365 (1962).

67 Loss, *supra* note 3, at 32.

68 Milton H. Cohen, *"Truth in Securities" Revisited*, 79 HARV. L. REV. 1340, 1341 (1966).

69 Adam C. Pritchard, *Revisiting "Truth in Securities" Revisited*: *Abolishing IPOs and Harnessing Private Markets in the Public Good*, 36 SEATTLE UNIV. LAW REV 999, 1001 (2013).

70 Louis Loss, *Disclosure as Preventive Enforcement,* CORPORATE GOVERNANCE AND DIRECTORS' LIABILITIES 327, 331 (Klaus J. Hopt & Gunther Teubner eds., 1985).

71 Norman S. Poser, *Securities Regulation in Developing Countries: The Brazilian Experience*, 52 VA. LAW REV. 1283, 1283 (1966).

72 *See* Solaiman, *supra* note 9.

information belongs to issuers, and ideally, the public can know only what is disclosed to them. Hence, there is a serious informational gap between issuing company managements and their potential investors.[73] There is a corporate tendency to inflate material positive expectations and hide material negative information that may prevent the investing public from buying their securities.[74] The disclosure regime aims to create a level playing field by closing, or at least narrowing, this gap.[75]

To that end, issuers of securities are required to disclose prescribed information and any other material information related to investment decisions by investors and their advisors. The contents of a disclosure document are thus split into two− specific disclosure (prescribed) and general disclosure (non-specified).[76] The general disclosure component imposes obligation on issuers to determine which information may be material to investors and their financial advisors. There are no black and white rules as to which information is material with respect to investment in a given offer of securities. The general disclosure items are to be considered on a case-by-case basis.

Further, corporate issuers of securities have no obligation to disclose information which should be obvious to a reasonable investor.[77] Courts thus impliedly ascribe responsibility on investors who are expected to be reasonable to work out the economic fundamentals of their issuers.[78] Besides, in courts' view, reasonable investors should be aware of general financial conditions[79] as well as understand a core portfolio theory called "diversification" of investments.[80] As this theory suggests, never put all your eggs in the same basket.[81] Such a high standard and expectation of courts about investors are inconsistent with and unlikely to

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[73] *See* H. Nejat Seyhun, *The Effectiveness of the Insider-Trading Sanctions,* 35 J.L. & ECON. 149, 158-67
(1992).

[74] *See* Peek v. Gurney (1873) LR 6 (HL) 377; Houghton v. Saunders (2018) NZSC 74; Royce de R. Barondes, *Adequacy of Disclosure of Restrictions on Flipping IPO Securities*, 74 TUL. L. REV. 883 (2000).

[75] *See* Marcel Kahan, *Securities Law and the Social Costs of "Inaccurate" Stock Prices,* 41 DUKE L.J 977 (1992); Mark A. Sargent, *State Disclosure Regulation and the Allocation of Regulatory Responsibilities,* 46 MOD. L. REV. 1027, 1044 (1987).

[76] *See, e.g.*, *Corporations Act 2001* (Cth), §§ 710-711 (Austl.).

[77] Barbara Black, *Behavioral Economics and Investor Protection: Reasonable Investors, Efficient Markets,* 44 LOY. U. CHI. L.J. 1493, 1494 (2013).

[78] *See In re* Merck & Co. Sec. Litig., 432 F.3d 261, 270–71 (3d Cir. 2005); Stefan J. Padfield, *Who Should Do the Math? Materiality Issues in Disclosures that Require Investors to Calculate the Bottom Line*, 34 PEPP. L. REV. 927, 943–44 (2007).

[79] *In re* Donald Trump Casino Sec. Litig., 7 F.3d 357, 377 (3d Cir. 1993).

[80] Dodds v. Cigna Sec., Inc., 12 F.3d 346, 351 (2d Cir. 1993).

[81] *See* Michael C. Macchiarola, *Securities Linked to the Performance of Tiger Woods? Not Such a Long Shot*, 42 CREIGHTON L. REV. 29, 43 (2008).

conform to reality.[82] Several recent studies reveal a gloomy picture of investor's investment knowledge, where retailers, in particular, lack basic or elementary financial literacy.[83] It is argued that people have cognitive biases which limit their ability to act rationally, therefore they "need more protection than they would in the standard rational model."[84] Human beings are fallible and prone to cognitive biases affecting their assessments of risks related to investment.[85] The human tendency is to underestimate potential risks and overestimate one's own ability to avoid those risks, in particular, risks which are likely to eventually affect that person. Ignoring underestimation of potential risks by overoptimism is a human tendency, this is applicable to particularly the risk that band bad things are likely to happen to oneself. [86]

The "anchoring effect"[87] is another cognitive bias , which results in overestimating the probability of success and underestimating the likelihood of failure.[88] Nobel laureate psychologist and behavioral economics scholar Professor Daniel Kahneman comments that "errors of intuitive thought are often difficult to prevent."[89] Professor Kahneman warns that humans are subject to the fallacies, illusions, biases, and heuristics in making their decisions.[90] Just because officers and managers hold corporate positions, does not mean that they are immune from these fallacies.[91] Rather, decision-makers of corporations and the organizations

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[82] *See* Margaret V. Sachs, *Materiality and Social Change: The Case for Replacing "the Reasonable Investor" with "the Least Sophisticated Investor" in Inefficient Markets*, 81 TUL. L. REV. 473, 473 (2006); David A. Hoffman, *The "Duty" to Be a Rational Shareholder*, 90 MINN. L. REV. 537, 538–39 (2006).

[83] *See, e.g.*, U.S. Securities and Exchange Commission, *Study Regarding Financial Literacy Among Investors,* at vii–viii (2012), https://www.sec.gov/files/917-financial-literacy-study-part1.pdf (last visited Oct. 30, 2023) [hereinafter U.S. SEC, 2012].

[84] Daniel Kahneman, *Behavioral Economics and Investor Protection: Keynote Address*, 44 LOY. U. CHI. L.J. 1333, 1330 (2013).

[85] Michael J. Kaufman, *Foreword: Behavioral Econimis and Investor Protection*, 44 LOY. U. CHI. L.J. 1323, 1324 (2013).

[86] *See* Moses L. Pava & Marc J. Epstein, *How Good is MD&A as an Investment Tool?*, 175 J. ACCT. 51, 52–53 (1993); Cass R. Sunstein, *Behavioral Analysis of Law*, 64 U. CHI. L. REV. 1175, 1183 (1997); Shelley E. Taylor & Jonathan D. Brown, *Illusion and Well-Being: A Social Psychological Perspective on Mental Health*, 103 PSYCHOL. BULL. 193, 196–97 (1988).

[87] The phrase "anchoring effect" refers to a cognitive bias behavior showing the common human tendency to rely too heavily on the first piece of information offered or received (the first piece of information offered is called the "anchor"; Pon Staff, *The Anchoring Effect and How it Can Impact Your Negotiation*, (Aug. 08, 2023), https://www.pon.harvard.edu/daily/negotiation-skills-daily/the-drawbacks-of-goals/.

[88] *See, e.g.*, Bainbridge, *supra* note 15, at 1046; Ann M. Olazábal, *Behavioral Science and Scienter in Class Action Securities Fraud Litigation*, 44 LOY. U. CHI. L. J. 1423, 1428 (2013).

[89] Olazábal, *supra* note 89, at 1432-33.

[90] *Id*. at 1436 (citations omitted).

[91] *Id*.

themselves "are also plagued by cognitive biases that may predispose them to reckless predictions and otherwise unfounded public statements."[92]

When these same errors and biases are shown by those on the supply side of securities, it may harm innocent investors. Gatekeepers and members of an IPO coalition like lawyers, directors, auditors, have been unable to provide the necessary safeguards to vulnerable investors.[93] More importantly, neither legislative actions nor judicial efforts have succeeded in improving the quality of corporate disclosure statements related to securities.[94] In addition, prosecutorial actions pursued by criminal and regulatory authorities have been terribly ineffective[95] even in the U.S. context which has played the leading role in attracting others to adopt the DBR.

Apart from the irregularities of the supply side and weaknesses in enforcement of securities laws, investors also need protection from "their own mistakes" as well as from many predatory, though not necessarily unlawful, activities of others in securities markets.[96] According to Judge Richard Posner, a United States Court of Appeals judge and one of the most influential jurists in the U.S.,[97] investors' unreasonable investment decisions can also be attributed to "securities professionals who see profit opportunities in exploiting investor behavior and cognitive biases."[98] Professor Black convincingly proves that research conducted on behavioral economics "supports the need for (at least some) paternalistic responses to cognitive biases,"[99] which should go beyond the prevailing disclosure obligations.[100]

The DBR aims to protect investors by enabling them to make informed investment decisions on whether to buy offered securities.[101] The utilization of

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92 *Id*. at 1445.

93 Donald C. Langevoort, *Chasing the Greased Pig Down Wall Street: A Gatekeeper's Guide to the Psychology, Culture, and Ethics of Financial Risk Taking*, 96 CORNELL L. REV. 1209, 1214 (2011).

94 *See* Ann Morales Olazábal*, Defining Recklessness: A Doctrinal Approach to Deterrence of Open Market Securities Fraud,* 2010 WIS. L. REV. 1415, 1445-59 (2010).

95 *See* Abbe David Lowell & Kathryn C. Arnold, *Corporate Crime after 2000: A New Law Enforcement Challenge or Déjà Vu?*, 40 AM. CRIM. L. REV. 219, 229–31 (2003)*;* Greg Hitt, *Corporate Reform: The First Year: SEC Chief Says Worst of Fraud is Likely Past; Federal Task Force Set Up to Investigate Wrongdoing Marks a Year on the Beat,* WALL ST. J. (2003); Peter Schweizer*, Obama's DOJ and Wall Street: Too Big for Jail?,* FORBES (2012), as cited in Olazábal, *supra* note 89, at 1437.

96 Kahneman, *supra* note 85, at 1340.

97 *See* David Campbell, *Welfare Economics for Capitalists: The Economic Consequences of Judge Posner*, 33 CARDOZO L. REV. 2233, 2234 (2012).

98 Richard A. Posner, *Behavioral Finance before Kahneman*, 44 LOY. U. CHI. L.J. 1341, 1343 (2013).

99 Black, *supra* note 78, at 1507.

100 Kaufman, *supra* note 86, at 1332.

101 The Treasury, *Government of Australia, Financial System Inquiry* (1996) Final Report, Chapter 7, at 249, https://treasury.gov.au/sites/default/files/2019-03/11-fsi-fr-chapt07.pdf; Phoebe Tapley &

disclosed information and achievement of investor protection may lead to several issues, some of which are discussed below.

A. Truth in Disclosures for Initial Public Offerings

A central logic behind the disclosure philosophy is to enable investors to make informed decisions by arming them with true and adequate information. In turn, this will enhance market integrity and efficiency.[102] But this logic is frustrated by frauds, which in securities markets are an old phenomenon. The GFC 2008 and the multibillion-dollar Ponzi scheme of Bernie Madoff – the largest financial fraud of all time –[103] are two of the best examples in modern times that manifestly unveiled that both small retailers and sophisticated institutional investors are "vulnerable to irrational exuberance and, at times, outright fraud" and to the risks inherent in complex financial products.[104]

The nature of the information gap between issuers of securities and their buyers is argued to justify the introduction of the DBR.[105] If we accept that justification, telling the truth to the public is the essence of the disclosure philosophy, the elimination of informational asymmetry will protect investors from frauds.[106] With this end in view, ruling out the responsibility of the U.S. Federal Government to approve and guarantee any merits of IPOs, President Roosevelt in his message to Congress on March 29, 1933, recommending legislation of the *Securities Act 1933* said:

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed from the buying public.
> This proposal adds to the ancient rule of caveat emptor, the further doctrine 'let the seller also beware.' It puts the burden of telling the

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Andrew Godwin, *Disclosure (Dis)content: Regulating Disclosure in Prospectuses and Product Disclosure Statements*, 38 COMPANY AND SECURITIES L.J. 315, 323 (2021).

[102] Tyro A. Paredes, *Blinded by the Light: Information Overload and Its Consequences for Securities Regulation*, 81 Wash. U. L.Q. 417-18 (2003).

[103] *See* Stavros Gadinis & Colby Mangels, *Collaborative Gatekeepers*, 73 WASH. & LEE L. REV. 797, 813-14, 817 (2016), about Madoff's fraud. Adam Hayes, *Bernie Madoff: Who He Was, How His Ponzi Scheme Worked*, INVESTOPEDIA (Mar. 29, 2023), https://www.investopedia.com/terms/b/bernard-madoff.asp (last visited Oct. 10, 2023).

[104] Saule T. Omarova, *The New Crisis for the New Century: Some Observations on the "Big-Picture" Lessons of the Global Financial Crisis of 2008,* 13(1) N.C. BANKING INST. 157, 161 (2009).

[105] *See* Steven Shavell, *Acquisition and Disclosure of Information Prior to Sale,* 25(1) RAND J. ECON. 20 (1994); Guttentag, *supra* note 7, at 977.

[106] Chapman v. Dunn, 414 F.2d 153, 156 (6th Cir. 1969).

> whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.[107]

Accordingly, §§ 11, 12(a)(2), 15 and 17 of the *Securities Act, 1933*[108] prohibit the inclusion of false and misleading statements as well as the omission of material information from the disclosure document.[109] *The Securities Act of 1933* requires issuers to make full disclosures to the public and strongly warns against "untrue" statements or omissions that may make the disclosure misleading.[110]

Hence, a disclosure document must be free from false statements, misleading information, or omissions of material information. This flawlessness may be true in theory, but not in practice. Managers of issuers sometimes deliberately publish false and misleading information for their personal advantages,[111] especially when facing the impending collapse of the company.[112] This makes subscribers even more helpless if their investment contracts are rescinded, and they must seek compensation for their losses due to the issuers' lack of funds. The individual investors may eventually end up losing their life savings without any remedy.

B. Adequacy of Information in Disclosures for Initial Public Offerings

The concept of "adequacy" of information overlaps with the concept of "truth" of information to some extent. Nevertheless, it is fair to discuss them separately. This is because the word "truth" is exclusively focused on the lack of truth or honestly, whilst "adequacy" considers other shortcomings and mischievous behaviors of issuers regarding the content in a disclosure document. The term "adequate information" is an inherently vague and abstruse. This has created confusion in the complex task of securities regulation,[113] because the exact type or amount of information that must be disclosed may not be easily determined. Issuers benefit from such an ambiguity. They consider themselves to be compliant with this obligation, because issuers have the right to assume that their responses are

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[107] H.R. REP. NO. 85 73rd Congress, First Session 2 (1933) quoted in *Dunn* 414, F.2d 153, 156-57 (1969).

[108] The equivalent sections of the *Securities Exchange Act 1934* (U.S.) are §§ 10(b) and 20(a), however, this legislation applies to the secondary securities market, whilst *Securities Act 1933* (U.S.) is designed for the primary or IPO market.

[109] For details, *see* Marc I. Steinberg, *U.S. Prospectus Liability — An Overview and Critique*, 14(2) J. EUROP. TORT L. 124 (2023).

[110] *See, e.g.*, Securities Act of 1933, 15 U.S.C. § 77k; Cohen, *supra* note 68, at 1353.

[111] *E.g.*, John C. Coffee Jr, *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1562 (2006). *See also* Merritt B. Fox, *Why Civil Liability for Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 209 (2009).

[112] Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Market: Theory and Evidence*, UNIV. ILL. LAW REV. 691, 725 (1992).

[113] *See* Richard L. Epling & Terrence W. Thompson, *Securities Disclosure in Bankruptcy*, 39(3) BUS. LAW. 855, 884-85, 904 (1984).

accurate and complete under the general disclosure requirement. Readers of disclosures believe that issuers are compliant when they see that issuers are responding to that obligation, .[114] Such ambiguities are amplified by the use of other terms sometimes synonymous with and modifying the term "adequate information".[115] For example, the terms "information," "disclosure," and "facts" are frequently used interchangeably along with certain adjectives that include "full,"[116] "frank,"[117] "careful,"[118]"effective,"[119]"fair,"[120]"best,"[121]"'sufficient,"[122]"enough,"[123] "understandable,"[124] "necessary,"[125] "accurate,"[126] "meaningful,"[127] "correct.,"[128][129]

It may sound theoretically good to assume that corporations disclose all their material information in their prescribed disclosure documents, but in practice this is a fiction, as commented by Professor Edmund Kitch, a corporate and securities law professor of Virginia Law School.[130] He adds that disclosure documents of securities issuers seldom disclose all material corporate information.[131] Professor Susanna Ripken goes further in commenting that "in practical terms, corporate disclosure documents today are riddled with formalized

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[114] Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 106- 5*, 57 VANO. L. REV. 1639, 1680 (2004).
[115] *See* Epling & Thompson, *supra* note 114, at 884.
[116] *See, e.g.,* Mobil Corp. v. Marathon Oil Co., 669 F.2d 366, 372 (6th Cir. 1981); SEC v. Ralston Purina Co., 346 U.S. 119, 124 (1953); *In re* Occidental Petroleum Corp., SEC Release No. 16, 950.
[117] *See, e.g.,* SEC v. Capital Gains Bureau, 375 U.S. 180, 197-200 (1963); United States v. El Paso Co., 682 F.2d 530, 544 (5th Cir. 1982).
[118] *See, e.g.,* United Housing Found., Inc. v. Forman, 421 U.S. 837, 868 (1975).
[119] Agency Rent-A-Car, v. Connolly, 686 F.2d 1029, 1034 (1st Cir. 1982); Feit v. Leasco Data Processing Equip. Corp., 332 F. Supp. 544, 564 (E.D.N.Y. 1971).
[120] *See, e.g.,* Camelot Indus. v. Vista Resources, Inc., 535 F. Supp. 1174, 1183 (S.D.N.Y. 1982).
[121] *See, e.g.,* Freeman v. Decio, 584 F.2d 186, 190 (7th Cir. 1978).
[122] *See, e.g.,* Gartenberg v. Merrill Lynch Asset Management, Inc., 694 F.2d 923, 933 (2d Cir. 1982); Pacific Realty Trust v. APC Investments, Inc., 685 F.2d 1083, 1087 (9th Cir. 1982).
[123] *See, e.g.*, United States v. Poludniak, 657 F.2d 948, 950 (8th Cir. 1981); Little v. Valley Nat. Bank of Arizona, 650 F.2d 218, 221 (9th Cir. 1981).
[124] *See, e.g.,* SEC v. Republic Nat'l. Life Ins. Co., 383 F. Supp. 436, 441 (S.D.N.Y. 1974).
[125] *See, e.g.,* Edgar v. MITE Corp., 457 U.S. 624, 634 (1982).
[126] *See, e.g., In re* Carl M. Loeb, Rhoades & Co., 38 SEC 843 (1959); Zell v. Intercapital Income Sec., Inc., 675 F.2d 1041, 1047 (9th Cir. 1982).
[127] *See, e.g.,* Daniel v. Int'l Bhd. of Teamsters, 561 F.2d 1223, 1247 (7th Cir. 1977); SEC v. Mgmt. Dynamics Inc., 515 F.2d 801, 806 (2d Cir. 1975).
[128] *See, e.g.,* Shivers v. Amerco, 670 F.2d 826, 834 (9th Cir. 1982); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 757 (1975).
[129] As cited in Epling & Thompson, *supra* note 114, at 884-85.
[130] Edmund W. Kitch, *The Theory and Practice of Securities Disclosure,* 61(3) BROOK. L. REV. 763, 775-76 (1995).
[131] *Id*. at 875-76.

language written by corporate attorneys to protect companies from liability, rather than to provide investors with meaningful information."[132]

The adequacy of information in a disclosure document is an essential legal requirement,[133] which is corrupted by both untrue and misleading information as well as by material omissions. Non-disclosure of material information is called "materiality blind-spots" and has the potential to diminish public confidence in market and corporate governance by tainting the accuracy of the prices of securities as well as making monitoring for fraud difficult.[134] Adequacy does not mean a huge amount of information has to be incorporated into the disclosure document, rather the requirement is satisfied by precisely useful and easily graspable information of a reasonable amount that portrays the strengths and weaknesses of the offer However, the determination of those pieces of information itself is a formidable task. Even the "general" disclosure requirement,[135] which is left for the judgment of issuers may sound problematic for both the issuers and their potential investors, and it "leaves one at sea in dealing with the concept of adequate information."[136] Commentators are also critical of "specific" disclosure requirements and argue that it is neither possible nor desirable to specifically stipulate fixed rules requiring certain pieces of information to be published. [137] Instead, each case should be considered and assessed on its own facts and merits. [138] Overall, the determination of both the items and the adequacy of information to be disclosed itself is a challenging job and there is no easy fix to overcome such bewilderment.

The complexity sketched above demonstrates that the concept of disclosure adequacy is ambiguous, which is exacerbated by several other synonymously used words in satisfying the requirement of corporate compliance. It is also argued that corporate issuers of securities give greater emphasis to compliance with the legal requirement to avoid legal proceedings compared to an intention to assist potential investors in understanding the strengths and weaknesses of an underlying offer.[139] These elements are hostile to attaining the actual purpose of eliminating information asymmetry by disclosure. In addition, the lack of competence of the investing public to meaningfully assess the information disclosed cannot be denied as will be shown below.

The impropriety in the professed truth and adequacy in disclosures adversely affect more retail, individual, or unsophisticated (used synonymously) investors than their sophisticated counterparts, mainly because of limitations of

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[132] Ripken, *supra* note 11, at 148.

[133] *See* Securities Act of 1933, 10 U.S.C. § 77j; *Corporations Act 2001* (Cth) ss 710, 711 (Austl.).

[134] George S. Georgiev, *Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation*, 64(3) UCLA L. REV. 602, 606, 608 (2017).

[135] *See* Securities Act of 1933, 10 U.S.C. § 77j; *Corporations Act 2001* (Cth) s 710 (Austl.).

[136] Epling & Thompson, *supra* note 114, at 855.

[137] *Id*. at 910-11.

[138] *Id*.

[139] *See* Langevoort & Gulati, *supra* note 115, at 1680.

their ability to fruitfully process the information so disclosed. Both the lack of whole truth and inadequacy have the potential to stain making informed decisions by investors with limited ability, as the discussion ensues.

C. Investors' Ability to Properly Understand and Utilize the Information Disclosed

1. Complexity in Financial Literature

For any law to be useful, it must correspond to its acceptability and usability in its proper context. There can be little or no dispute in admitting that financial literature is complex and technical, and therefore not readily understood and utilized by anyone.[140] Business lawyer Edward McDermott comments that "the law governing [securities] manipulations has become an embarrassment - confusing, contradictory, complex, and unsophisticated."[141]The complication is significantly exacerbated when the intended users are unable to understand the meaning and consequences of the information disclosed even if that portrays the truth. The literature cannot be simplified to the extent it is expected to be. For example, referring to the Australian federal laws, an impact statement of *Corporations Amendment Regulations 2010* notes that despite several attempts to streamline them,[142] the "vast majority of the disclosure provisions" embodied in the *Corporations Act 2001* (Cth) remain very complex.[143] Commentators find that even though regulatory philosophies have evolved over the past decades with efforts to streamline corporate disclosures to make those easier to understand, "the reforms had simply added to its volume and complexity."[144]

A good investment decision requires investors to analyze "the chance of positive returns against the risk of loss".[145] The risks that need to be assessed by investors inclusively include "a range of other risks, such as inflation, foreign currency, or liquidity risks."[146] Are they able to do so with scant or no investment

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[140] J. H. Lorie, P. Dodd & M. H. Kimpton, THE STOCK MARKET: THEORIES AND EVIDENCE (Illinois: Dow Jones -Irwin 2nd ed. 1985) at viii.

[141] Edward T. McDermott, *Defining Manipulations in Commodity Futures Trading: The Futures "Squeeze",* 74 NW. U. L. REV. 202, 205 (1979-80).

[142] *See Regulatory Guide 228 Prospectuses: Effective Disclosure for Retail Investors 2019* (ASIC)(Austl.) (hereinafter ASIC, RG 228); *Regulatory Guide 168 Disclosure: Product Disclosure Statements (and Other Disclosure Obligations) 2022* (ASIC)(Austl.) (hereinafter ASIC, RG 168).

[143] Regulation Impact Statement, *Corporations Amendment Regulations 2010 (No. 5)* (Cth)(Austl.), *cited in* Nicholas Simoes da Silva & William Isdale, *Risk and Reform in Australian Financial Services Law*, 96(6) AUSTL. L. J. 408, 419 (2022).

[144] *See id*. at 419.

[145] ASIC and Dutch Authority, *supra* note 25, at 10.

[146] Silva & Isdale, *supra* note 144, at 410.

knowledge? That is the most crucial question. Evidence shows that particularly retail investors are unbale to do so, as alluded to above.[147]

2. Financial Innovation Adding to the Complexity of Investment Literature

This is the age of financial innovation through the proliferation of complex derivative products. In other words, this is an "era of ever-increasing complexity in the financial industry".[148] Risks continually evolve with the creation of new financial products, compounded by the rising risks of existing products.[149] Financial innovations and proliferations that aim to mask the risks inherent in the new products add additional complexity to already complex disclosures. Derivative debt products should be strictly regulated through a paternalistic assessment of merits. Financial innovations sometimes artificially amplify the asset price. We do not need a boom in asset prices;[150] rather, booms are needed in the asset themselves – an asset price boom was a serious factor of the last financial crisis.[151] The complexity in financial derivative products cannot be denied given that many sophisticated investors and experienced institutional buyers lost the most in the last GFC.[152] It is widely recognized that the securitized products (MBS, ABS, CDO, CDO^2, CDO^3, etc) that played a central role in the GFC generally did not comply with disclosure requirements.[153] Evidenced by the complexity of products and pertinent disclosures, the GFC has taught us that although the "slicing and dicing" of financial risk may decrease risk exposure for individual market players, it intends to increase the overall risk and vulnerability of the financial system.[154] The complex nature of the products made their disclosure technically or practically inadequate.[155] The extent of complexity was so remarkable that even institutional investors, let alone retailers, did not understand the risks they assumed by investing in these derivatives.[156] Even financial experts believed that the disclosures were impenetrable and therefore potentially incomprehensible to any single person.[157]

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147 *See generally* ASIC and Dutch Authority, *supra* note 25.
148 Geoffrey Rapp, *Rewiring the DNA of Securities Fraud Litigation: Amgen's Missed Opportunity*, 44(5) LOY. U. CHI. L. J. 1475, 1475 (2013) (internal citation omitted).
149 Silva & Isdale, *supra* note 144, at 411.
150 Discussions of the issue of 'boom in asset prices' are not included in this paper in order to keep this piece within a certain word limit, however, it will be separately discussed in another paper.
151 Grant Kirkpatrick, *The Corporate Governance Lessons from the Financial Crisis*, OCED J.: Fin. Mkt. Trends, Oct. 2009, at 4.
152 Steven L Schwarcz, *Disclosure's Failure in the Subprime Mortgage Crisis*, 2008(3) UTAH L. REV. 1109, 1121 (2008).
153 *Id*. at 1113.
154 Omarova, *supra* note 105, at 162.
155 Schwarcz, *supra* note 153, at 1113.
156 *Id*. at 1114.
157 *See* David Barboza, *Complex El Paso Partnerships Puzzle Analysis*, N.Y. TIMES, Jul. 23, 2002, at C1.

The issuers of these products were driven by the intent to transfer the risks of subprime lenders to less deserving or undeserving borrowers.[158] They knowingly took the unreasonable risks with a *mala fide* intention of offloading them onto innocent investors by securitizing and then selling the loans. Securitization and collateralization debt obligations, taking advantage of the disclosure philosophy, have paved the way for financial innovation. As a result, investment products have become increasingly more complicated, thereby rendering them challenging for investors to understand and analyze from an investment perspective[159] Highlighting the complexity of the debt financial products, Professor Steven Schwarcz, Stanley A. Star Distinguished Professor of Law & Business at Duke University, asserts that these are so complex that it is hard for sophisticated institutional investors and professional securities analysts to penetrate them and grasp the risks and rewards inherent in these securities.[160] Warren Buffett, a U.S. business magnet and one of the most successful investors of all time, described the subprime credit derivative products as "financial weapons of mass destruction".[161] Along the same line, European governments have also favoured more substantive merit regulation of public offerings.[162]

Those products are offered to both general and institutional investors in such a reality that even most Americans, who are expected to be general or individual investors, do not have the basic level of knowledge of financial literature.[163] Educating investors overnight to help general investors to understand the disclosure should just be an unrealistic expectation, even if it were such a target, it might never be reached. A similar view has been expressed by Professor Barbara Black that "[l]t is simply unrealistic to expect unsophisticated investors to read lengthy disclosure documents, and given their complexity, it would be a waste of investors' time."[164] These (opinions/comments/etc) reinforce that the disclosure literature is generally inaccessible for retailers, and sometimes even for sophisticated investors .

To clarify any potential of misunderstanding of the Australian reform at hand, it is important to mention that the newly introduced provisions governing

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[158] *See* Solaiman, *supra* note 9 (detailing how the last GFC was played out).

[159] *See* Henry T.C. Hu, *Too Complex to Depict?: Innovation, "Pure Information", and the SEC Disclosure Paradigm,* 90(7) TEX. L. REV. 1601, 1602 (2012).

[160] *See* Steven L. Schwarcz, *Rethinking the Disclosure Paradigm in a World of Complexity,* 2004 U. ILL. L. REV. 1, 4-6, 8; Morrissey, *supra* note 61, at 658-65.

[161] Morrissey, *supra* note 61, at 687.

[162] Damian Paletta & Kara Scannell, *Ten Questions for Those Fixing the Financial Mess,* WALL ST. J., Mar. 10, 2009, at A10; Morrissey, *supra* note 61, at 688.

[163] *See* Luigi Zingales, *The Future of Securities Regulation,* 47 J. ACCT. RES. 391, 409 (2009). *See also* William R. Emmons, *Consumer-Finance Myths and Other Obstacles to Financial Literacy,* 24 ST. LOUIS U. PUB. L. REV. 335, 339 (2005); Annamaria Lusardi & Olivia S. Mitchell, *Financial Literacy and Retirement Preparedness: Evidence and Implications for Financial Education,* 42 BUS. ECON. 35, 36 (2007).

[164] Black, *supra* note 78, at 1506.

DDOs and PIPs are cautiously optimistic that these reforms will not significantly affect financial innovation.[165] Rather they are expected to be facilitative of innovative disclosure.[166] Moreover, the Murray Inquiry was tasked with the responsibility "to identify any emerging opportunities and challenges likely to drive change in the financial system, including the role of new technologies, market innovations, and consumers, changes in the sources and uses of capital, and the nature of corporate governance structures in the financial system and their effect on stakeholders."[167] Hence, the expected or potential innovation has been carefully considered, therefore concerns about any negative impact of the reform at hand on financial innovation can be reasonably excluded.

3. Materiality of Information

All material information must be disclosed. The responsibility for determining the materiality of information is initially entrusted with issuers. Materiality is defined as information that a reasonable investor would consider important in making an investment decision.[168] The U.S. Supreme Court defines materiality as "information a reasonable investor would consider significant in making an investment decision."[169] This interpretation relies heavily on the common law concept of material information.[170] In relation to the materiality of an omitted fact, the U.S. Supreme Court held in *TSC Industries Inc. v. Northway Inc* that:

> It does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote. What the standard does contemplate is the showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholders. Put another way, there must be a substantial likelihood that disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.[171]

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[165] FSI Final Report 2014, *supra* note 21, at 194, 210.
[166] *Id*. at 214.
[167] Andrew C. Worthington, *Consumer Outcomes of the 2014 Financial System Inquiry,* J. Sec. Inst. Austl. 57, 57 (2015).
[168] *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976); Basic Inc. v. Levinson, 485 U.S. 224, 232 (1988).
[169] B*asic Inc.* 485 U.S. at 231. *See also TSC Indus., Inc.*, 426 U.S. at 449.
[170] *See, e.g.*, Holdsworth v. Strong, 545 F.2d 687, 698 (10th Cir. 1976).
[171] *TSC Indus., Inc*., 426 U.S. at 448.

In *Cackett v. Keswick***,** the Court of Appeal in the UK held that, a statement will be material if it would have an impact on a reasonable investor, or such an investor is influenced or induced in making an investment decision based on the prospectus.[172] Lord Halsbury LC in *Arnison v. Smith* made a classic formulation of such inducement by saying that:

> A person reading the prospectus looks at it as a whole . . . You cannot weigh the elements by ounces . . . if a court sees on the face of the statement that is of such a nature as would induce a person to enter into the contact, or would tend to induce him to do so, or that it would be part of the inducement to enter into the contact, the inference is, if he [or she] entered into the contact, that he [or she] acted on the inducement.[173]

In this respect, the U.S. Supreme Court states that courts should not consider reasonable investors like "nitwits"[174] and attribute to them "child-like simplicity."[175] Issuers can misuse this test by including puffery statements in the disclosure document and then claim, if any dispute arises, that a reasonable person would not be misled by exaggeration of information not material in law.[176] The court in *Johnson v. Songwriter Collective, LLC*, finds that some degree of "puffing" or "sales talk" is acceptable.[177] Also, ambiguous assertions in the disclosure document and "extremely contingent or highly speculative possibilities" are not considered material.[178] This permits some leeway for issuers regarding the expectations of a reasonable investor, which may militate against the interest of individual investors.

To determine the materiality of information through an objective test, the U.S. securities watchdog (SEC) looks to typical retailers to define a reasonable person.[179] However, according to Professor Geoffrey Rapp, "[t]he reasonable investor is neither a sophisticated money manager nor an electronically savvy day trader. Rather, the reasonable investor is an ordinary person who invests money in

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172 *Cackett v Keswick* (1902) 2 Ch 456 at para 2 (per Farwell J).

173 *Arnison v Smith* (1889) 41 Ch D 348, 369.

174 Basic Inc. v. Levinson, 485 U.S. 224, 234 (1988) (quoting Flamm v. Eberstadt, 814 F.2d 1169, 1175 (7th Cir. 1987)).

175 *Id.*

176 Bogart v. Shearson Lehman Bros., Inc., No. 91 CIV. 1036 (LBS) (NG), 1995 WL 46399, at 1-2 (S.D.N.Y. 1995). *See also* Peter H. Huang, *Moody Investing and the Supreme Court: Rethinking the Materiality of Information and the Reasonableness of Investors*, 13 SUP. CT. ECON. REV. 99, 112–18 (2005).

177 Johnson v. Songwriter Collective, LLC, No. 3:05-0320, 2006 WL 861490, at 12 (M.D. Tenn. Mar. 28, 2006).

178 Hazen, *supra* note 47, at 485, 464.

179 Stefan J. Padfield, *Immaterial Lies: Condoning Deceit in the Name of Securities Regulation*, 61 CASE W. RES. L. REV. 143, 155 (2010).

securities subject to the SEC's regulatory authority."[180] In addition to the lack of ability to understand and analysis the information embodied in disclosure documents, there is a behavioral constraint that these reasonable investors care very little about disclosed information in making their investment decisions, which should be recognized by courts.[181]

Therefore, the materiality of information is tested by applying an ordinary reasonable person test. In the case of an omitted fact, materiality would be determined on a substantial likelihood that a reasonable investor would consider the matter important in deciding on the offer if it were disclosed.[182] The concept of a "reasonable investor" is an artificial construct, and studies of behavioral economics on cognitive failings suggest that such artificiality results in lack of investor protection, especially unsophisticated retailers.[183]

Given the complexity and uncertainty of defining materiality in the present context, scholars, for example, Professor Stephan Padfield, recommends lessening the role or significance of materiality as a "gatekeeper" in dealing with frauds around securities.[184] Going one step further, Professor Geoffrey Rapp advocates for ordinary investors by suggesting the requirement of materiality be dropped altogether for fraud cases when a retailer becomes victim.[185] Premised on this lack and need for the protection, behavioral economists advocate for a paternalistic response to cognitive biases.[186] They ask "[h]ow can we allow people of varying abilities and financial sophistication to express their preferences for investments without making them vulnerable to salespeople selling 'snake oil'?"[187] Thus, it can, be inferred that the requirement of materiality and a corresponding reasonable person test may effectively protect retailers.

4. Cognitive and Behavioral Biases of Investors

The problem is not only the investors' lack of knowledge and complexity of the literature, but the cognitive biases affecting their independent assessment of an IPO.[188] Nevertheless, they are expected to analyze both disclosed and apparently obvious information. This is because corporate issuers have no obligation to disclose any information obvious to a reasonable investor.[189] Courts thus implicitly ascribe responsibility on investors, expecting them to be reasonable to "do the

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[180] Rapp, *supra* note 149, at 1481.
[181] *Id*. at 1482.
[182] Solaiman, *supra* note 2, at 50.
[183] Black, *supra* note 78, at 1507.
[184] Padfield, *supra* note 180, 193.
[185] Rapp, *supra* note 149, at 1483.
[186] George A. Akerlof & Robert J. Shiller, ANIMAL SPIRITS: HOW HUMAN PSYCHOLOGY DRIVES THE ECONOMY, AND WHY IT MATTERS FOR GLOBAL CAPITALISM 175 (2009).
[187] *Id.*
[188] *See* Solaiman, *supra* note 2, at 50.
[189] Black, *supra* note 78, at 1494.

math" to work out the economic fundamentals of their issuers.[190] Moreover, reasonable investors are expected to be aware of general financial conditions[191] and understand a core portfolio theory called "diversification" of investments.[192] As this theory suggests, never put all your eggs in the same basket.[193] These high standards and expectations are inconsistent with and unlikely to align with reality.[194] Several recent studies reveal a gloomy picture of investors' investment knowledge, where retailers, in particular, lack basic or elementary financial literacy.[195] Cognitive biases are said to limit their ability to act rationally, thereby requiring "more protection than they would in the standard rational model."[196] Human beings are not infallible. They are prone to many cognitive biases affecting their assessment, including investment.[197]Ignoring or underestimating potential risks associated with investment being influenced by overoptimism is a human tendency.[198]

The "anchoring effect"[199] is another well-understood cognitive bias, which can result in the overestimation of the probability of one's success and underestimation of the likelihood of one's failure.[200] Nobel laureate psychologist Professor Daniel Kahneman comments: "Errors of intuitive thought are often difficult to prevent."[201] Generally, people tend to overestimate their capability to foretell end results of their actions perfectly. [202] Scholars of behavioral economics and psychology, including Professor Kahneman, have warned the reality that humas are subject to fallacies, illusions, biases, and heuristics when making decisions and forming conclusions.[203] Corporate officers and managers are not immune.[204] Decision-makers of corporations and the organizations themselves "are

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190 *See In re* Merck & Co., Inc. Sec. Litig., 432 F.3d 261, 270–271 (3d Cir. 2005); Padfield, *supra* note 79, at 943–44.
191 *In re* Donald J. Trump Casino Sec. Litig.-Taj Mahal Litig., 7 F.3d 357, 377 (3d Cir. 1993).
192 Dodds v. Cigna Sec., Inc., 12 F.3d 346, 351 (2d Cir. 1993).
193 *See* Macchiarola, *supra* note 82.
194 *See* Sachs, *supra* note 83, at 473; Hoffman, *supra* note 83, at 538–39.
195 *See, e.g.,* U.S.SEC, *supra* note 84.
196 Kahneman, *supra* note 85, at 1330.
197 Kaufman, *supra* note 86, at 1324.
198 *See* Pava & Epstein, *supra* note 87, at 52−53; Sunstein, *supra* note 87, at 1183.; Taylor & Brown, *supra* note 87, at 196−97.
199 The phrase "anchoring effect" refer to a cognitive bias behaviour showing the common human tendency to rely too heavily on the first piece of information offered or received (the first piece of information offered is called the "anchor"); Staff, *supra* note 88.
200 *See, e.g.,* Bainbridge, *supra* note 15, at 1046.
201 Olazábal, *supra* note 89, at 1432-33.
202 Hersh Shefrin, BEYOND GREED AND FEAR: UNDERSTANDING BEHAVIORAL FINANCE AND THE PSYCHOLOGY OF INVESTING 51 (2002); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism,* 97 NORTHWESTERN UNIV. L. REV. 1165, 1172 (2003).
203 Olazábal, *supra* note 89, at 1436.
204 *Id*.

also plagued by cognitive biases that may predispose them to reckless predictions and otherwise unfounded public statements."[205]

This means that the same errors and biases are present in the supply side of securities, which may eventually harm innocent investors. Gatekeepers and members of an IPO coalition like lawyers, directors, and auditors have been unable to provide the necessary safeguards for the vulnerable.[206] Perhaps, more importantly, neither legislative actions nor judicial efforts have been successful in ameliorating the quality of corporate disclosure statements related to securities.[207] This further exacerbates the investors' helplessness.

Prosecutorial actions pursued by both criminal and regulatory authorities have been ineffective[208] even in the U.S. context, which has played a leading role in attracting others to adopt the DBR.

Apart from the irregularities of the supply side and weaknesses in enforcement of securities laws, investors need protection not only from "their own mistakes" but also from many predatory, though not necessarily unlawful, activities of others in securities markets.[209] According to Judge Richard Posner, a Justice of the United States Court of Appeals and one of the most influential jurists in the U.S.,[210] investors' unreasonable investment decisions can also be attributed to "securities professionals who see profit opportunities in exploiting that behavior."[211] Likewise, Professor Black convincingly proves that research conducted on behavioral economics "supports the need for (at least some) paternalistic responses to cognitive biases,"[212] which should be extended to investor protection initiatives going beyond the prevailing disclosure obligations.[213]

Having learned lessons from the GFC, many anti-regulation hardliners, such as former Treasury Secretary Henry Paulson of the U.S., have become proponents of more stringent government control of financial markets.[214] In the aftermath of the GFC, Professor Elizabeth Warren of Harvard Law School proposed legislation to introduce reform along the lines of MBR at the federal level

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[205] *Id*. at 1445.
[206] Langevoort, *supra* note 94, at 1214.
[207] *See* Olazábal, *supra* note 95, at 1445-59.
[208] *See* Lowell & Arnold, *supra* note 96, at 229–31*;* Hitt, *supra* note 96*;* Schweizer, *supra* note 96; Olazábal, *supra* note 89, at 1437.
[209] Kahneman, *supra* note 85, at 1340.
[210] *See* Campbell, *supra* note 98, at 2234.
[211] Posner, *supra* note 99, at 1343.
[212] Black, *supra* note 78, at 1507.
[213] Kaufman, *supra* note 86, at 1332.
[214] Julia Werdigier, *Paulson Calls for Giving Regulators More Powers*, N.Y. TIMES Jul. 3, 2008, at C2, as cited in Morrissey, *supra* note 61, at 687.

in the U.S.[215] It is also suggested that the U.S. SEC should have the authority to "flat-out prohibit the sale of certain investments that pose undue risks to our entire economic system."[216] Australian Securities and Investments Commission (ASIC), the principal corporate regulator in Australia, and its Dutch equivalent have jointly admitted that "[d]isclosure is not then the silver bullet it was once believed to be,"[217] which prompted reform in Australia's disclosure regime.

The discussion above shows the flaws in the disclosure philosophy, in terms of investor protection, mainly in the U.S. and Australian context. Then, it can be easily perceived as to what the situation can be like in developing markets. Having considered the usefulness and effectiveness of the DBR, some commentators argue that the philosophy is fundamentally limited in its effectiveness and has outright failed to protect investors.[218] Expressing deep vexation about the DBR, Professor Ronald Colombo, a securities law professor, comments that "the concern is not so much about protecting investors from themselves, but about protecting everyone from those who would invest imprudently."[219] Despite several attempts to simplify and streamline disclosure to make it easily understandable,[220] the texts of corporate disclosures remain very complex,[221] resulting in persistent "unfair consumer outcomes" leading to further amendments to the disclosure requirements with effect from 2021. Disclosure is thus no longer considered to be panacea, but rather has turned to be a pandora's box.[222]

Drawing on the failure of heavy reliance on the original disclosure philosophy, the fundraising provisions contained in the *Corporations Act, 2001* (Australia) have been amended to introduce Design and Distribution Obligations (DDOs) together with the ASIC's Product Intervention Powers (PIPs) as regulatory tools to improve consumer outcomes.[223] As alluded to above, the reforms resemble a striking feature of merit regulation. A major argument to support paternalism is to help those whose "judgment is [so] impaired due to immaturity, ignorance, incompetence, or the like" that they fail to realize that they are about to cause harm

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215 *See* Elizabeth Warren, *Unsafe at Any Rate,* 5 DEMOCRACY J. 8, 9 (2007). *See also* Elizabeth Warren & Amelia Warren Tyagi, *Protect Financial Consumers,* HARPER'S MAG., November 2008, at 39, as cited in Morrissey, *supra* note 61, at 687.

216 Morrissey, *supra* note 61, at 687.

217 ASIC & Dutch Authority, *supra* note 25, at 51.

218 *See* Tamar Frankel, *The Failure of Investor Protection by Disclosure,* 81 UNIV. CINCINNATI. L. REV. 421, 423, 435 (2012); Omri Ben-Shahar & Carl E. Schneider, *The Failure of Mandated Disclosure,* 159 UNIV. PA. L. REV. 647, 651 (2011).

219 Colombo, *supra* note 29, at 6. *See also* Meir Statman, *Regulating Financial Markets: Protecting Us from Ourselves and Others*, 65 FIN. ANALYSTS J. 23, 30 (2009).

220 See ASIC, RG 228, *supra* note 143; ASIC, ASIC RG 168, *supra* note 143.

221 Silva & Isdale, *supra* note 144, at 419.

222 *See* Solaiman, *supra* note 9.

223 *Corporations Act 2001* (Cth), ss 994A-994Q, s 1023A-1023R; ASIC, PRODUCT INTERVENTION POWER, REGULATORY GUIDE 272 (2020) (hereinafter ASIC, RG 272).

to self-interests.[224] The regime with "more direct regulation" is argued to be useful for stopping corporate misconduct around fundraising.[225] These overhauls are dedicated to prevent fraud and provide much needed support to retail investors.

V. Introduction to Design and Distribution Obligations in Australia

Australia has adopted the extreme disclosure philosophy in line with U.S. federal law by divorcing its merit regulation in the late 1980s. However, successive financial system inquiries reveal that the DBR has been ineffective, particularly in protecting retail investors. The Financial System Inquiry Report 2014 (FSI 2014 or Murray Report 2014), the third of its kind in Australia over the past 30 odd years, is the main architect of the DDOs and PPIs regime.[226] The first of the three inquiries is known as the Australian Financial System Inquiry 1979 (FSI 1979, or Campbell Report 1979), which contributed to promoting deregulation of financial sector. The second one is called the Financial System Inquiry 1996 (FSI 1996 or Wallis Report 1996), which was instrumental in reshaping the financial services regulation and forming the current regulatory authorities.[227] Murray Report 2014 is built on its predecessors. The modifications in the disclosure philosophy were premised by the findings that "[t]he existing framework relies heavily on disclosure, financial advice and financial literacy. The FSI 1996 notes that disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioral biases, misaligned interests and low financial literacy."[228] Their findings include that poor products have recently been issued to the public. This warrants the alignment of retailers' interests at the starting point of product design, followed by a strengthened distribution strategies and advice.[229] This prompted the FSI 2014 to submit Recommendation 21 to introduce a targeted and principles-based product design and distribution obligation.[230] The new reforms aim to achieve reduction in "the number of consumers buying products that do not match their needs, reduction of consequent significant consumer detriment", and promotion of "fair treatment of consumers by firms that design and distribute financial products." [231] The reforms also aim to promote "efficiency, limit or avoid the future need for more prescriptive regulation," and build "confidence and trust in the financial system."[232]

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224 David J. Garren, *Paternalism, Part II: Justificatory Gyrations,* 48 PHIL. BOOKS 50, 52 (2007).
225 Ripken, *supra* note 11, at 202.
226 Worthington, *supra* note 168, at 57.
227 *Id*.
228 FSI Final Report 2014, *supra* note 23, at 199.
229 *Id.* at 193.
230 *Id*. at 198.
231 *Id*. at 199.
232 *Id*.

The seeds of the DDOs of issuers of financial products were thus ingrained in the FSI 2014. "[U]nfair consumer outcomes remain prevalent"[233] despite the implementation of the preceding the Wallis Report 1996 even though the FSI 1996 was devoted to improving "fair and efficient markets" in Australia.[234] To address this dismal finding of financial consumer outcomes, the Murray Report 2014 recommends a fundamental departure from the pre-existing disclosure philosophy,[235] which had been applying for a long time in a manner that one size fits all. Consumers' engagement with the risk associated with investment remains a central concern in the Murray 2014 report, as it highlights that "[c]onsumers should have the freedom to take financial risks and bear the consequences of these risks. However, the inquiry is concerned that consumers are taking risks they might not have taken if they were well informed or better advised."[236] It reviews the pre-existing regulatory framework concerning, amongst other things, financial consumer outcomes with an emphasis on disclosure, financial advice, and financial literacy.[237] The Murray Report finds that although product disclosure has an important role to play, the regulatory system was not helpful for consumers to make informed decisions, and financial literacy was not conducive to fair outcomes for consumers either.[238] The FSI 2014 then submits eight recommendations regarding consumer outcomes (Recommendations 21-26, 40-41),[239] which include increasing government regulation in relation to disclosure (Recommendation 21)[240] and regulatory intervention powers (Recommendation 22).[241] The recommendations of the FSI 2014 on consumer outcomes "seek to strengthen the current framework to promote consumer trust in the system and fair treatment of consumers."[242] In response to the Murray Report 2014, the Federal Parliament of Australia has enacted legislation titled *Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Act 2019* (Cth) to amend the Corporations Act, 2001 (CA 2001) embodying DDOs and PIPs. DDOs offer evidence of a paradigm shift in the regulatory philosophy of financial products in Australia, aiming to provide support to financial consumers in securing appropriate products suitable to their needs.

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[233] *Id.* at xiii.
[234] COMMONWEALTH OF AUSTRALIA, FINANCIAL SYSTEM INQUIRY FINAL REPORT 178 (1996) (also known as the FSI 1996, Wallis Report or Wallis Inquiry).
[235] Silva & Isdale, *supra* note 144, at 420.
[236] FSI Final Report 2014, *supra* note 23, at 28.
[237] THE TREASURY, AUSTRALIAN GOVERNMENT, FINANCIAL SYSTEM INQUIRY 2014, FINANCIAL SYSTEM INQUIRY INTERIM REPORT 178 (2014).
[238] Worthington, *supra* note 168, at 58.
[239] THE TREASURY, AUSTRALIAN GOVERNMENT, AUSTRALIAN GOVERNMENT FINANCIAL INQUIRY, FACT SHEET: CONSUMER OUTCOMES 1 (2014).
[240] Recommendation 21 of the FSI 2014: Strengthen product issuer and distributor accountability.
[241] Recommendation 22 of the FSI 2014: Introduce product intervention power.
[242] FSI Final Report 2014, *supra* note 21, at xx. As quoted in Commonwealth of Australia.

Most of the recommendations of the Murray Inquiry 2014 around consumer outcomes have been well received and are expected to improve overall consumer trust and confidence in the national financial system.[243] Several experts and professionals alike have expressed a similar view in commenting that the "'paradigm shift away from the reliance on point of sale measures like disclosure, financial advice, and consumer financial literacy' is one of the defining and radical features of the recommendations furnished by the Murray Inquiry, and others add that in adopting a pragmatic outcomes-based approach and avoiding overly prescriptive statements, the inquiry has taken 'the right approach.'"[244] Despite that Recommendation 21, which provides for DDOs, is regarded as one of the most radical outcomes offered of the FSI 2014, it has been most welcomed pointing out "both the expected ease of implementation, in that existing controls can be simply scaled up to the new standard, and also that the more costly prospect of individual appropriateness tests at the point of sale for complex products."[245]

The DDOs are a consumer-centric approach to designing and distributing products,[246] and a deviation from the exclusive dependence on the disclosure philosophy.[247]This introduction manifestly acknowledges that the prevailing disclosure regulation has resulted in poor consumer outcomes.[248]The DDOs and PIPs regime is certainly leaned towards paternalistic regulation to protect consumers from the issuers' unhelpful, if not culpable, disclosures. It has been well argued that substantive regulation aimed at restraining issuers' improper conduct helps strengthen investor confidence in the market.[249]

A. Scope of the Design and Distribution Obligations

The scope of the DDOs & PIPs Act 2019 is broad.[250] The DDOs apply to financial products including securities which require disclosure under Parts 6D.2 (§§703B-725) and 7.9 of the *Corporations Act 2001* (Cth).[251] Part 6D.2 relates to disclosure to investors about securities (other than for crowd-sourced funding offers), which is the concern of this Article. Part 7.9 is about financial products other than securities (financial product disclosure and other provisions relating to issue, sale, and purchase of financial products),[252] which are beyond the coverage of this endeavor. The DDOs extend their coverage to products that are not regulated

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243 Worthington, *supra* note 168, at 60.
244 *Id*.
245 *Id*. at 61.
246 ASIC, *supra* note 25, at RG 274.5.
247 Silva & Isdale, *supra* note 144, at 420.
248 ASIC, *supra* note 25, at RG 274.3. *See also* THE TREASURY, AUSTRALIAN GOVERNMENT, FINANCIAL SYSTEM INQUIRY: INTERIM REPORT 3-57 (2014).
249 Ripken, *supra* note 11, at 201.
250 Corporations Act 2001 § 994B (Austl.).
251 ASIC, *supra* note 25, at RG 274.19 fig. 1.
252 *See* Corporations Act, *supra* note 251.

under the aforesaid Parts 6D.2 or 7.9 of the *Corporations Act 2001* (Cth), but are within the scope of the *Australian Securities and Investments Commission Act 2001* (Cth) (ASIC Act 2001), such as credit contracts and short-term credit facilities, which are also placed outside the scope of this Article. ASIC RG274 also provides a list on exclusions of other products which are not related to the present paper either.[253] Instead, this Article is concerned with public offers of securities, and from this point of view, the only notable exception to application of DDOs to public offers is "fully paid ordinary shares."[254] Section 254A of the *Corporations Act 2001* (Cth) empowers companies to issue different types of shares including fully paid, partly paid, bonus, preference, and redeemable preference shares. Of these, only fully paid ordinary shares are excluded from the scope of the DDOs. In addition to the different types of shares, companies in Australia are also permitted to issue debt securities, such as debentures and simple bonds.[255] Thus, the DDOs apply to all preference shares, debt securities, and options for equity and debts fundraising products.

B. Design and Distribution Obligations Regime and Its Operation− Issuers' Key Obligations under the DDOs & PIPs Act 2019

The DDOs & PIPs Act 2019 imposes certain duties on both issuers and distributors of securities and enables ASIC to intervene in the issuing process if any provisions prescribed for governing public issues to retail investors are flouted. The scope and key DDOs are discussed below.

1. Issuers' Obligation to Prepare the Target Market Determination

It is the responsibility of issuers who intend to issue their securities to retail investors to first determine the target market, called the Target Market Determination (TMD). Then distributors are obligated to distribute those products exclusively to the target market.[256] Setting out a TMD is mandatory for relevant issuers,— it must include the information relating to the product distribution and the information monitoring investor outcomes.[257]

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[253] ASIC, *supra* note 20, at RG 274.19 Figure 1.
[254] *Id*. at RG 274.21.
[255] *See* Corporations Act, *supra* note 251; ASIC, *supra* note 20, at RG 274.136–274.138.
[256] Australian Government−The Treasury, *Updated Amendments to the Design and Distribution Obligation* (Austl.), https://treasury.gov.au/sites/default/files/2021-09/c2019-t408904-206688.pdf (last visited Aug. 04, 2023).
[257] ASIC, *FAQs: Design and Distribution Obligations for Advice Licensees and Financial Advisers* (Sept. 16, 2021), https://asic.gov.au/regulatory-resources/financial-services/giving-financial-product-advice/faqs-design-and-distribution-obligations-for-advice-licensees-and-financial-advisers/ (last visited Jul. 22, 2023).

The preparation of the TMD must comply with the prescribed rules detailed in the legislation and ASIC regulatory guide.[258] ASIC regulatory guides generally provide an explanation as to how the regulator may exercise its statutory powers, explain the ways in which the watchdog interprets the laws for their application in practice, describe principles underlying the regulator's approach to interpretation of laws, and offer practical guidance for the application of laws.[259] ASIC Regulatory 274 provides a useful guide on the DDOs. Issuers shall have to make the TMD publicly available free of charge before distributing their securities.[260] The target market refers to the class of investors the issuer intends to issue its securities. Investors mean retail investors or consumers, as opposed to sophisticated and institutional investors with respect to DDOs. In preparing the TMD, the issuer must consider, amongst other things, the suitability, likely objectives, financial situation, and needs of retailers.[261] The defining TDM has been a critical issue as 15 of the 26 stop orders ("stop orders" will be discussed right after the discussion of DDOs below) [262] issued by ASIC from October 2021 to early July 2023 are related to this definition.[263]

2. Issuers Obligation to Take Reasonable Steps in Relation to Distribution

Section 994E(1) of the *Corporations Act 2001* (Cth) imposes a binding obligation to take reasonable steps concerning distribution of the products. The objective of this obligation is to make sure that the distribution remains consistent with the TMD prepared for the products.[264] In order to satisfy this obligation, issuers are required to implement effective arrangements that are likely to direct distribution of the financial product to the target market.[265] In doing so, issuers must consider all relevant factors including:

> (a) risk—the likelihood of the distribution being inconsistent with the TMD; (b) harm—the nature and degree of harm that might result from the financial product being distributed otherwise than in accordance with the TMD; and (c) mitigation steps—steps that can be taken to eliminate or minimise the likelihood of the

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[258] *See* Corporations Act, *supra* note 251; ASIC, *supra* note 20, at RG 274.59–274.135.
[259] ASIC, RG 272 *supra* note 224, at 2.
[260] *See* Corporations Act, *supra* note 251.
[261] ASIC, *supra* note 258.
[262] ASIC has the power to issue stop orders under § 994J of the *Corporations Act 2001* (Austl.).
[263] Michael Bracken, *ASIC Calls for Improvements to the Design and Distribution of Investment Products*, Colin Biggers & Paisley Lawyers (Jul. 10, 2023), https://www.cbp.com.au/insights/insights/2023/july/asic-calls-for-improvements-to-the-design-and-dist (last visited Jul. 15, 23).
[264] *See* ASIC, *supra* note 20, at RG 274.139–274.147.
[265] *Id*. at RG 274.139.

distribution being inconsistent with the TMD and the harm that might result.[266]

3. Issuers' Obligation to Review the TMD to Ensure Its Continued Appropriateness

Unlike the typical disclosure requirements, the obligations under the DDOs & PIPs Act 2019 on issuers and distributors do not end with the issuance of the securities, but rather both are also required to build and maintain effective governance arrangements for the whole life cycle of the issued financial products.[267] As part of the continued obligation, issuers are obligated to conduct a review to make sure that the TMD remains appropriate. Issuers must carry out review of the TMD within ten business days if they know, or ought reasonably to know, that a review has been triggered, or an event or circumstance that reasonably suggests that the TMD is no longer appropriate has occurred.[268]

4. Issuer's Obligation to Notify ASIC of Inconsistent Dealings

Section 994G of the *Corporations Act 2001* (Cth) obligates an issuer to notify ASIC if the issuer becomes aware of "significant dealings" in its securities about a retail client by a person in a manner inconsistent with the TMD. The issuer must give written notice to ASIC as soon as practicable, and in any case within ten business days, after becoming aware. The rules are thus very strict, and the issuer may have serious legal consequences if they fail to abide by the obligations under § 994G.[269]

5. Issuers' Obligation to Keep Records of the DTM and Subsequent Reviews

To ensure that an issuer is properly complying with the obligations stated above, records must be collected and kept on file about the TMD decisions and subsequent review being conducted with reasons thereof. The records must be complete and accurate, including storing relevant data. The records must include distribution information as well, to the extent that the issuer engages in distribution.[270] The issuer may be required by ASIC to submit these records to them

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[266] *See Corporations Act 2001* §994(E)(5) (Austl.). For further details, *see* ASIC, *supra* note 20, at RG 274.41.

[267] Australian Government−The Treasury, *Updated Amendments to the Design and Distribution Obligation* (Austl.), https://treasury.gov.au/sites/default/files/2021-09/c2019-t408904-206688.pdf (last visited Aug. 04, 2023).

[268] *See Corporations Act 2001* § 994C (Austl.); *See* ASIC, *supra* note 20, at RG 274.148–274.156.

[269] *See* § 994E of the *Corporations Act 2001* (Austl.) and ASIC, *supra* note 20, at RG 274.157–274.162.

[270] *See Corporations Act 2001* § 994F (Austl.); ASIC, *supra* note 20, at RG 274.165–274.166.

for the confirmation that the obligations have been complied with.[271] The DDOs & PIPs Act 2019 imposes similar obligations on distributors of securities designed for retailers.

C. Design and Distribution Obligations Regime and Its Operation− Distributors' Key Obligations under the DDOs & PIPs Act 2019

1. Distributors' Obligations Not to Distribute without a TMD

Section 994D of the *Corporations Act, 2001* (Cth) prescribes the rules regarding prohibition on engaging in retail product distribution conduct unless a TMD had been made. Section 994D obligates a distributor not to engage in the conduct in relation to the product unless it believes on reasonable grounds based on all reasonable inquiries that a TMD had been made, or a TMD is not required for the product, or the product is excluded from the conduct.[272] More simply, a distributor is generally barred from engaging in conduct relating to distribution of securities where a TMD is required, but such a determination has not been made.[273] It clearly means that a distributor cannot ignore the TDM at its own discretion and can do so only based on a reasonable belief the disputed conduct does not breach this defined obligation.

2. Distributor's Obligation to Take Reasonable Steps in Relation to Distribution

Section 994E(3) of the *Corporations Act, 2019* (Cth) strictly requires distributors to take reasonable steps regarding distribution much in the same way as issuers are required to do so. The steps are those which are reasonably likely to, result in distribution being consistent with the most recent TMD, excluded conduct is excepted. Section 994E(5) contains a list of reasonable steps required by this obligation. Section 994E(5) provides:

> … ***reasonable steps*** in relation to a person are steps that, in the circumstances, the person is reasonably able to take that will, or are reasonably likely to, result in retail product distribution conduct in relation to the financial product being consistent with the target market determination for the product, taking into account all relevant matters, including:
> (a) the likelihood of any such conduct being inconsistent with the determination; and

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[271] ASIC, *supra* note 20, at RG 274.165.
[272] *See* Corporations Act 2001, §994D (Austl.); ASIC, *supra note* 20, at RG 274.168.
[273] ASIC, *supra* note 20, at RG 274.168.

(b) the nature and degree of harm that might result from an issue or regulated sale of the financial product:
(i) to retail clients who are not in the target market; or
(ii) that is inconsistent with the determination; and
(c) what the person knows, or ought reasonably to know, about:
(i) the matters referred to in paragraphs (a) and (b); and
(ii) ways of eliminating or minimising the likelihood and the harm; and
(d) the availability and suitability of ways to eliminate or minimise the likelihood and the harm.[274]

Noticeably, emphasis has been given to the compliance and consistency with the TMD for the relevant product, and it aims to ensure that the distribution is made within the target market and that it does minimize harm to financial consumers.

3. Distributor's Obligation to Notify "Significant Dealings" in the Financial Product Inconsistent with the TMD

Distributors are obliged to notify their issuers of a "significant dealing" in the relevant product that is not consistent with the TMD as ordained in § 994F(6) of the *Corporations Act 2001* (Cth). As shown above, the issuer also has an obligation to notify the ASIC under § 994G of a "significant dealing." When the distributor becomes aware of a significant dealing in the product and also comes to know that the dealing is not consistent with the target market determination− a notification must be made as soon as practicable however, in any case within 10 business days, after becoming so aware.[275] The overall provisions of this obligation of distributors conform to their equivalent prescribed for issuers dealing in the product, and that the dealing is not consistent with the target market determination, the notification must be made as soon as practicable, but at most, within 10 business days, after becoming so aware.[276] The obligations of distributors are equivalent to those prescribed for issuers.

4. Distributor's Obligation to Keep Records of Its Conduct

Distributors have a binding obligation under § 994F(3) of the *Corporations Act, 2001* (Cth) to keep complete and accurate records of distribution information, which include the number of complaints received about the product and

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[274] Corporations Act, *supra* note 270.
[275] Corporations Act 2001, §994F(6) (Austl.); ASIC, supra note 20, at RG 274.211.
[276] For further details, *see* Corporations Act, *supra* note 271 at §994F(6); ASIC, *supra* note 20, at RG 274.211-274.215.

information specified by the issuer in the TMD.[277] As a regulated person, the distributor must collect and keep complete and accurate records of the following distribution information about the securities:

> (a) the number of complaints of the product that the regulated person receives;
> (b) the steps the regulated person has taken as required by section 994E (reasonable steps to ensure consistency with the target market determination);
> (c) if the regulated person is specified in the determination as required to report information of a specified kind to the person who made the determination (see subparagraph 994B(5)(h)(i))−information of that kind that the regulated person acquires;
> (d) if the regulated person is not the person that made the determination--the dates on which the regulated person reported as required by subsection (4), (5) or (6) and the substance of the reports.

This obligation of distributors resembles that of the issuer stated above and underscores the need for the exercise of due diligence and transparency towards all duties imposed under the DDOs & PIPs Act 2019. Record-keeping is mandatory, probably because distributors play a critical role through their direct interactions with the end-users of the financial products.[278] For example, distributors are required to collect distribution information to ensure that the information flows back to the respective securities issuers.[279] Distributors shall have to keep the records of distribution for a period up to seven years.[280]

Keeping good distribution records is both directly and indirectly supportive of other obligations. Good records are expected to be useful for the distributor in monitoring its governance processes and controls to meet reasonable steps and other requirements within DDOs.[281] Further, ASIC may request these records to verify that the distributor has discharged its obligations properly in compliance with the law. The records held by the distributor are likely helpful for them to demonstrate that they have taken all the necessary steps to comply with its binding obligations.[282]

All the obligations of issuers and distributors are equally subject to both civil penalty and criminal liability provisions. This is mentioned repeatedly in all the sections of the *Corporations Act 2001* (Cth) that created these obligations.

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[277] ASIC, *supra* note 20, at RG 274.216-274.22.
[278] *Id*. at RG 274.216.
[279] *See* Corporations Act, *supra* note 271 at § 994F(2)–(6); ASIC, *supra* note 20, at RG 274.216.
[280] *See Corporations Act 2001* § 1101C (Austl.); ASIC, *supra* note 20, at RG 274.220.
[281] ASIC, *supra* note 20, at RG 274.222.
[282] *Id*. at RG 274.223.

These penalty and liability provisions are all designed to ensure the protection of retailers by preventing the harm being caused to them. Obligations surrounding the TMD, taking reasonable steps with respect to distribution, reviewing the TMD, notification, keeping records of all these actions speak to the overarching need for investor protection, particularly those investors who are vulnerable. Unlike the traditional disclosure philosophy in which issuers' obligations end through disclosing "the whole truth" (if they do at all), the DDOs regime extends the obligation of both issuers and distributors to build and maintain effective governance arrangements for the entire life cycle of the issued securities.[283] After preparing the TMD, the issuer and distributor will have to develop the distribution process of the product to ensure that these are issued or sold to consumers within the target market only. [284] These new obligations represent the regulatory philosophy that seller must make sure that their products are suitable for the targeted end-users.[285] It should be noted that ASIC has the power to provide relief by extending and excluding the strict application of DDOs, by considering the intentions of the legislature underlying the obligations pertinent to the waiver and extension, including the potential impact of relief on consumers.[286]

The other most notable reforms made by the DDOs & PIPs Act 2019 is giving intervention powers to ASIC called PIPs. PIPs have supplemented DDOs as a tool of protection for retail clients of financial products, including securities, by issuing stop orders at any stage of the issuance process as discussed below.

VI. Consumer Detriment and Regulatory Powers for Product Intervention under the DDOs & PIPs Act 2019

PIPs are regarded as one of the several strengths ASIC can employ to protect investors and promote consumer outcomes.[287] PIPs are one of several regulatory tools available to ASIC to improve consumer outcomes, allowing ASIC to temporarily intervene in a range of ways, such as imposing a temporary ban on the issuance, or issuing stop orders if the regulator foresees a risk of significant consumer detriment.[288] ASIC may exercise these powers when it is satisfied that a product, or a certain class of products, have "resulted, will result, or is likely to result in significant consumer detriment."[289] Sections 1023A-1023R of the *Corporations Act 2001* (Cth) offer provisions governing PIPs, and ASIC

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[283] ASIC, *supra* note 20, at RG 274.6, RG 274.16, RG 274.32–RG 274.58.
[284] Silva & Isdale, *supra* note 144, at 420.
[285] FSI Final Report 2014, *supra* note 23, at 244.
[286] *See* ASIC, *supra* note 20, at RG 274.249–274.253.
[287] ASIC, *supra* note 224, at RG 272.
[288] *Id*.
[289] *See Corporations Act 2001* §1023D(1)(b) (Austl.); ASIC, *supra* note 224, at RG 272.68–272.69; *ASIC Act 2001* §102(2C) (Austl.).

Regulatory Guide 272 of 2020 explains the meaning and application of this critical regulatory power.

A. Meaning of Consumer Detriment

Although "detriment" is intended to have its ordinary meaning, the word in the present context embraces a wider meaning, covering a broad span of harm or damage that may arise from a financial product, whether it is concerning the feature of the product, defective disclosure, poor design, or inappropriate distribution.[290] The detriment, both financial and non-financial ,[291] relate to products sold that are misaligned with consumer needs, understanding or expectations.[292] The detriment may affect an individual investor or the whole market to varying degrees. The detriment can be evident immediately if a product is obviously inappropriate or missold at the point of sale. The detriment can also be hidden if the problem takes time to emerge.[293]

The *Corporations Act, 2001* (Cth) states that a "significant consumer detriment" is essential to trigger this power. However, the *Corporations Act, 2001* (Cth) does not define the word "significant." and its meaning is considered on a case-by-case basis.[294] However, the *Revised Explanatory Memorandum to the Treasury Laws Amendment (Design and Distribution Obligations and Product Intervention Powers) Bill 2019* provides that "[g]enerally, this would require the detriment [or potential detriment] to be sufficiently great to justify an intervention, having regard to the circumstances of the case and the object of the intervention power."[295] All of this shows the broadness of consumer interests that PIPs intend to address and protect.

B. Factors to be Taken into Consideration in Determining Consumer Detriment

The factors that ASIC takes into account in exercising PIPs are not exhaustive. The regulatory guide,[296] crafted based on the legislation, provides a non-exhaustive list of factors which include: (a) the nature and extent of the detriment; (b) without limiting paragraph (a), the actual or potential financial loss to consumers resulting from the product; (c) the impact that the detriment has had, will have or is likely to have on consumers; and (d) any other matter prescribed by

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290 ASIC, *supra* note 224, at RG 272.40.
291 *Id*. at RG 272.41.
292 *Id*. at RG 272.42.
293 *Id*. at RG 272.43-272-44.
294 *Id*. at RG 272.46. For further details of "significant detriment" *see id.* at 272.47-272.51.
295 *Id*.
296 ASIC, *supra* note 224, at RG 272.52.

regulations.[297] These factors are relevant in considering "significant consumer detriment" related to the securities in question. The presence of just one of these factors is sufficient to prove that the detriment is significant.[298]

C. Objectives of the Product Intervention Powers

The legislation declares that the primary objective of PIPs is to enable ASIC to take proactive action to prevent significant consumer detriment by reducing the risk of such consumer harm.[299] The regulatory guide elaborates on this objective.[300] ASIC states that PIPs have enabled the regulator to proactively respond to the problems surrounding DDOs in a flexible, targeted, effective, and timely manner and to act on a market-wide basis. Additionally, PIPs can be applied without a demonstrated or suspected breach of the law, which empowers the watchdog to act before significant detriment, or further detriment, is done to consumers. This helps ASIC better uphold social expectations regarding company operations.[301] To avoid confusion or over-expectation, the regulatory guide clarifies that PIPs are not intended to prevent or eliminate all risks associated with the financial products and markets (e.g., not a prudential tool to prevent market failures or corporate collapses).[302] Rather, the guide iterates that risks in the financial market cannot be eliminated because of its nature.[303] However, it adds that the PIPs "may, for example, enable interventions to mitigate the significant detriment that can arise when consumers are marketed and sold investment products that are inappropriate for their risk profile, or when they are unable to understand and/or assess the risk they are taking."[304]

D. Benefits of the Product Intervention Powers

Regulatory Guide 272 identifies the benefits of PIPs that include: (a) helping the regulator to "act more quickly and effectively to address the causes of significant consumer detriment in the market; (b) reduce the number of consumers at risk of significant detriment and for whom the terms, features and risks of a product are inappropriate for their objectives, financial situation and needs; and (c) ultimately—reduce significant detriment to consumers."[305] The benefits also

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[297] *See Corporations Act 2001* §1023E(1) (Austl.). Some other factors are listed in ASIC, *supra* note 224, at RG 272.53 and *Corporations Act 2001* §1023E(2) (Austl.).
[298] ASIC, *supra* note 224, at RG 272.54.
[299] *Corporations Act 2001* §1023A (Austl.).
[300] For details, *see* ASIC, *supra* note 224, at RG 272.1-272.7.
[301] *Id.* at RG 272.2. For details of the objectives of PIPs, *see id*.
[302] *Id.* at RG 272.6.
[303] *See id.* at RG 272.7, RG 272.45.
[304] *Id*.
[305] *Id*. at RG 272.8

include addressing market-wide problems to prevent significant consumer detriment more quickly than before the introduction of this reform.[306]

E. Types of Product Intervention Orders ASIC Can Make

ASIC has wide powers for product intervention, however, the legislation imposes some restrictions on their exercise. ASIC can make two types of orders under PIPs: (1) an individual product intervention order that applies to specific person(s);[307] and (2) a market-wide order applicable to a person, in relation to a "class" of products.[308] The latter is considered when the regulator seeks "to address a practice that is relatively widespread or, even if the practice is not currently relatively widespread, there is a risk the practice will be 'phoenixed'[309] or it is one that could be adopted by others." [310] The meaning of a "class" of products has been interpreted by the Federal Court of Australia in *Cigno Pty Ltd v Australian Securities and Investments Commission.*[311] Justice Stewart in this case held that "there is nothing in the word 'class' that requires there to be more than one financial product presently existing that is within the class".[312] Justice Stewart further explained that:

The relevant meaning of class is 'a set or category of things having some related properties or attributes in common, grouped together, and differentiated from others under a general name or description; a kind, a sort': *Oxford English Dictionary Online* (Oxford University Press, March 2020). Thus, 'class' is a taxonomical tool; it is a set or category with common characteristics. It is not necessary to the concept that there be more than one, or even one, existing thing within the class. There may be only an expectation that there might be a thing or things in the future with the characteristics of the class which will cause them to be categorised as part of the class if and when they come into existence[313]

F. How a Product Intervention Order is Made

Regulatory Guide 272 requires ASIC to make a participatory and transparent decision-making process to make a draft intervention order under PIPs. ASIC must consult with the parties who are likely to be affected.[314] Such

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[306] For more benefits, *see id*. at RG 272.9.
[307] *Corporations Act 2001* §1023D(1) (Austl.).
[308] *See Corporations Act 2001* §1023D(3) (Austl.). For a greater detail, *see* ASIC, *supra* note 224, at RG 272.21-272.225.
[309] ASIC, *supra* note 224, at RG 272.23-Note 1: Phoenix activity refers to that when a new entity is created to continue the business of an existing entity.
[310] *Id*. For some examples of interventions, *see id* at RG 272.26-272.30.
[311] *Cigno Pty Ltd v Australian Securities and Investments Commission* (2020) FCR 479 (Austl.).
[312] *Id*.
[313] *Id.* at 71-72.
[314] *See Corporations Act 2001* (Cth) § 1023F(1) (Austl.); ASIC, *supra* note 224, at RG 272.61.

consultations seek consultees' feedback on the regulator's proposal to intervene, and gauge the potential for significant consumer detriment identified by the watchdog. The draft intervention order may be modified based on the feedback.[315]

G. Public Notification of ASIC's Decisions Regarding Intervention Orders

ASIC must publish its decision made in exercising its PIPs on its website. The notification must describe the significant consumer detriment that has resulted, or is or will likely result from the relevant product, the propriety of the order, and findings in consultations carried out.[316] To comply with the confidentiality requirements, generally, non-confidential submissions by others will be published on the ASIC's website.[317] As a matter of principle, ASIC's view is that it should facilitate public awareness in the community where it operates its actions. Thus, such publications of its actions are important with respect to market integrity, investor confidence, strengthening deterrence and promoting public awareness.[318]

H. Consequences of Breaching a Product Intervention Order

As is the case with a breach of DDOs, a breach of a product intervention order is subject to both civil penalties[319] and criminal liability[320] ASIC is entitled to take an enforcement action against the person (natural or artificial) through civil penalty proceedings or criminal prosecution.[321] Consumers affected by a breach of product intervention order have the right to seek compensation or damages directly from the service provider. If the service provider fails to resolve the dispute, the aggrieved consumer can make a compliant to the Australian Financial Complaints Authority, and finally can take the matter to court.[322]

I. Response to the Criticism of Product Intervention Powers

PIPs are considered a departure from the pre-existing disclosure philosophy reliant on the traditional business principle called "caveat emptor" or "let the buyer

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[315] ASIC, *supra* note 224, at RG 272.63. For a greater detail of this consultation process and usage, *see* ASIC, *supra* note 224, at RG 272.61-272.69.
[316] For details, *see Corporations Act 2001* (Cth) § 1023L(3) (Austl.); ASIC, *supra* note 224, at RG 272.74-272.77.
[317] ASIC, *supra* note 224, at RG 272.74 (Note).
[318] *Id.* at RG 272.77.
[319] *Corporations Act 2001* (Cth) § 1023Q (Austl.); ASIC, *supra* note 224, at RG 272.92.
[320] *Corporations Act* 2001 (Cth) § 1023P (Austl.); ASIC, *supra* note 224, at RG 272.92.
[321] *Corporations Act 2001* (Cth) §§ 1023Q and 1023P (Austl.); ASIC, *supra* note 224, at RG 272.92.
[322] ASIC, *supra* note 224, at RG 272.93-272.95.

beware.[323] PIPs enable ASIC to issue orders banning the sale of certain financial products to retailers or the regulator may impose conditions on the sale of product in question.[324]

ASIC already had a "stop order power" under s 739 of the *Corporations Act, 2001* (Cth) before the introduction of the new reform. That provisions empowered the watchdog to take action only to rectify consumer detriment after a breach or suspected breach of the law by a corporation.[325] One of the limitations of that previous provisions that ASIC could enforce its powers against breaches causing consumer detriment is that the regulator (ASIC) could exercise its powers on a firm-by-firm basis, even if it was evident that the problem existed industry-wide.[326] Australia has experienced cases of substantial consumer harm where ASIC became helpless to take a further enforcement action after exhausting its own regulatory measures due to the absence of clear basis to take additional enforcement action.[327] Responding to this problem, the FSI 2014 has made a recommendation requiring introduction of "a proactive product intervention power that would enhance the regulatory toolkit available where there is risk of significant consumer detriment."[328] This recommendation aspires to achieve three specific objectives: reducing significant detriment from consumers buying financial products they do not understand, limiting or avoiding the future need for more prescriptive regulation, and building consumer confidence and trust in the financial system that would effectively improve market efficiency through increased consumer engagement and participation.[329] The new PIPs empower ASIC to intervene the insurance of securities to the public "without a demonstrated or suspected breach of the law", however, the regulator is due to be held to a high level of accountability whenever it is used.[330] Also, the PIPs should be used as a last resort, or pre-emptive measure in a situation where there is risk of significant consumer detriment, and the higher accountability provision has been added having regard to the potential commercial impact of the exercise of this power. [331] The watchdog has exercised PIPs on at least three occasions since its introduction by imposing ban on the sale of binary options to retailers.[332]

Some commentators argue that PIPs are contradictory to the principle stipulated in the FSI 2014[333] which asserts that consumers "should have the

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323 Silva & Isdale, *supra* note 144, at 420.
324 FSI Final Report 2014, *supra* note 23, at 206; *Id*.
325 For details, *see Corporations Act 2001* §§ 739-741 (Austl.).
326 Australian Government−The Treasury, *Australian Government Financial Inquiry, Fact Sheet: Consumer Outcomes*, 3 (2014).
327 FSI Final Report 2014, *supra* note 23, at 207.
328 *Id*. at 206 (Recommendation 22 of the FSIR 2014).
329 *Id.* at 207.
330 *Id*. at 206.
331 *Id*.
332 ASIC Corporations, *(Product Intervention Order – Binary Options) Instrument 2021/240* (Cth).
333 Silva & Isdale, *supra* note 144, at 421.

freedom to take financial risks and bear the consequences of these risks" [334] The critique seems to ignore that the Murray Report (FSI 2014) explains that "unfair consumer outcomes remain prevalent".[335] The report particularly refers to retail investors who are unable to understand the complex financial literacy used in disclosure documents, let alone assess the potential risks and rewards underlying a given public offer.[336] The FSI 2014 underlines that "disclosure can be ineffective for a number of reasons, including consumer disengagement, complexity of documents and products, behavioral biases, misaligned interests and low financial literacy."[337]

The Productivity Commission of the Government of Australia and others recognize the findings of behavioral economics and admit that retail investors understand risk factors poorly when they say that "the effectiveness of many traditional consumer protection approaches is diminished once you can no longer assume that consumers will seek out and understand all relevant information before purchasing a financial product."[338]

This lack of investors' ability to grasp disclosure prevents them from making an informed investment decision, resulting in "unfair consumer outcomes."[339] This is simply why the Murray Report recommends introduction of DDOs with respect to products targeted to retailers. The Murray Inquiry does not recommend the same obligations for other public offers. Since no persons can make any informed decision on any issue unless and until they can inform themselves the reason for their determination, the disclosure in question cannot help them. Hence, no controversy should arise on this point. Notably, attempts have been made several times to simplify the disclosure literature,[340] but unsuccessfully. Disclosures could not be simplified because of the inherent complexity of the financial jargons or the way of expressions of material information and the corporate culpability or lack of issuers' inclination to make disclosure easily understandable, as alluded to earlier. It is to be borne in mind that in the financial sector "One size does not fit all – the effects of disclosure are different from person

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334 FSI Final Report 2014, *supra* note 23, at 28.

335 *Id*. at xiii.

336 *Id*. at 199.

337 *Id.*

338 Productivity Commission, Australian Government, *Competition in the Australian Financial System* 87 (Inquiry Report No 89, Jun. 2018). For more details, *see* Anne-Francoise Lefevre & Michael Chapman, *Behavioural Economics and Financial Consumer Protection,* 5 (OECD Working Papers on Finance, Insurance and Private Pensions No 42, 2017); Geraint Howells, *The Potential and Limits of Consumer Empowerment by Information*, 32(3) J. OF L. & SOC'Y 349 (2005); Kristy Johnston, Christine Tether & Ashley Tomlinson, F*inancial Product Disclosure: Insights from Behavioural Economics* (Occasional Paper No 15/01, Ministry of Business, Innovation and Employment (NZ), February 2015); Russell Korobkin, *Bounded Rationality, Standard Form Contracts, and Unconscionability*, (2003) 70 U. CHI. L. REV. 1203 (2003).

339 Financial System Inquiry Final Report 2014 (FSIR 2014) pp xx, xiii, xx.

340 *See* ASIC, *supra* note 140 at RG 228; ASIC, *supra* note 143, at RG 168.

to person and situation to situation" as agreed by ASIC and its Dutch counterpart.[341] Hence, in the real world, disclosure sometimes causes harm to consumers in unexpected ways.[342] There is "no single, universal approach that suits everyone" and different investors read various parts of an IPO disclosure document differently and to different extents,[343]approach to disclosure that can satisfy the needs of all investors equally; rather, most of them are generalized and not intended to cater for the needs of a particular class of investors.[344] Hence disclosure itself is unlikely to be a solution.

The problems with disclosure are recognized by securities regulators themselves. It is acknowledged by some regulators that "[d]isclosure does not solve the complexity in financial services markets."[345] The culpability of corporations and the gullibility of investors are old problems.[346] Some companies are believed to intentionally make their products complex to confuse consumers (e.g., unclear fee descriptions for professionals such as auditors, lawyers, issue managers; discount for underwriters) and exploit the already complicated disclosure environment.[347] Consistent findings from Australian research indicate that only few consumers engage with long and complex disclosure documents, meaning a vast majority of them pays scant attention to such disclosures.[348] Only about 10 percent of consumers thoroughly go through the disclosure documents.[349] Consumers find them impenetrable, "too long, . . . too complex, and/or used difficult and technical language and concepts."[350] Many consumers also find them "not relevant" to their investment decisions.[351] If the disclosure document is too descriptive and voluminous, individual investors cannot digest, understand and

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[341] ASIC and Dutch Authority, *supra* note 25, at 5.

[342] *Id*. at 5, 34, 42.

[343] *Id*. at 39.

[344] ASIC, *Submissions of the Australian Securities and Investments Commission – Round 6: Insurance*, Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, at para 29(a) (2018), https://asic.gov.au/regulatory-resources/find-a-document/asic-submissions/ (last visited Jul. 20, 2023).

[345] ASIC and Dutch Authority, *supra* note 25, at 8.

[346] Loss, *supra* note 3.

[347] *See* Oren Bar-Gill, *Seduction By Contract: Law, Economics, And Psychology In Consumer Markets,* 18-20 (Oxford University Press, 2012); Xavier Gabaix & David Laibson, *Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets* 121(2) Q. J. ECON. 505 (2006).

[348] ASIC, Report 540− *Investors in Initial Public Offering* (REP 540, Aug. 2017); Where to Research, *Factors That Influence Retail Investors in IPOs*, 6 (Attachment to REP 540, August 2017); ASIC, Report 341−*Retail Investor Research into Structured Capital Protected and Capital Guaranteed Investments* (REP 341, May 2013); ASIC, Report 588− *Consumers' Experiences with the Sale of Direct Life Insurance* (REP 588, August 2018), as cited in ASIC and Dutch Authority, *supra* note 25, at 20.

[349] ASIC and Dutch Authority, *supra* note 25, at 21 (footnote 29).

[350] *Id.* at 21 (citations omitted).

[351] *Id*.

utilize them meaningfully in making their investment decisions.[352] When investors receive such a disclosure document, they either ignore it altogether or only selectively read some of its parts, which effectively frustrate the core objective of the disclosure philosophy: assisting the investing public in making informed decisions.[353]

Financial literature is obviously not something readily understood.[354] Making decisions on financial products is particularly complex mainly: it may have an emotional or behavioral dimension; the securities are intangible assets (chose in action, as opposed to chose in possession which is tangible); it generally involves uncertainty about future outcomes; and risks are often present in investments.[355]

Given the problems discussed, returning to MBR would be the best path because disclosure regulation cannot protect investors. Securities markets and investors would be better served if the regulatory philosophy conforms to the findings of behavioral economics and psychology that call for at least some degree of paternalistic regulation.[356] Behavioral economics, with its emphasis on investors' judgment errors, supports (at least to some degree) government paternalism.[357] Distinguished experts like Stanford Professor Gilson and Harvard Professor Kraakman recognize the need to protect individual investors through a degree of paternalism, considering the issues of behavioral finance and cognitive biases.[358]

As explained above, Australia no longer follows the original theme of the disclosure philosophy which has been considerably modified by the newly introduced DDOs and PIPs. DDOs represent "a significant shift in the regulation of financial products in Australia" as observed by the Australian Law Reform Commission (ALRC).[359]

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[352] *See* Jacob Jacoby, *Is It Rational to Assume Consumer Rationality?: Some Consumer Psychological Perspectives on Rational Choice Theory,* 6 ROGER WILLIAMS U. L. REV. 81, 133 (2000); *See also Ben*-Shahar & Schneider, *supra* note 217, at 721; TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976) ("Some information is of such dubious significance that insistence on its disclosure may accomplish more harm than good").

[353] *See* Ripken, *supra* note 11, at 160-62,185; *See also* Hu*, supra* note 41, at 2376-77.

[354] Solaiman, *supra* note 2, at 174; McDermott, *supra* note 142, at 205.

[355] ASIC and Dutch Authority, *supra* note 25, at 10.

[356] Olazábal, *supra* note 89, at 1445.

[357] *See generally* Cass R. Sunstein, *Libertarian Paternalism Is Not an Oxymoron*, 70 U. CHI. L. REV. 1159 (2003).

[358] Ronald J. Gilson & Reinier H. Kraakman, *The Mechanisms of Market Efficiency Twenty Years Later: The Hindsight Bias*, 28 J. CORP. L. 715, 738 (2003).

[359] Australian Law Reform Commission (ALRC), *Background Paper FLS5- Legislative Framework for Corporations and Financial Services Regulation*, at para 61 (2022) https://www.alrc.gov.au/wp-content/uploads/2022/03/FSL5-Risk-and-Reform.pdf.

VII. CONCLUSIONS – FINDINGS AND RECOMMENDATIONS

There is little dispute about the complexity and difficulties in the portfolio investment as analyzed above. Securities knowledge is not a "divine gift"− exceptions, if any, are excluded. Then how logical would it be to expect retailers who are mainly amateur investors with meagre, life or retirement savings to understand and analyze corporate fundraising disclosure? Consequently, these investors have to rely on luck for their investment decisions, which does not always work in their favor. There have been instances where individuals have committed suicide after losing their savings in securities investments.[360] Consistently, researchers have found a co-relation between stock market crashes and investors' suicides.[361] The protection of retail investors obviously needs more than mere disclosure.[362] Retailers, even the most sophisticated ones, are ill-equipped to protect themselves from the risks involved in securities investments.[363] The disclosure philosophy rests on the concept of extreme capitalism, and we need to revisit the myth that retailers are well protected by the DBR. Meticulous merit regulation by state-sponsored regulatory authorities equipped with adequate resources, rather than by amateurs themselves in portfolio investment, would be useful in assessing the merits in public offers. Such an assessment is critical to reducing the possibility of securities markets' bubbles and corresponding bursts, and the subsequent flow on effects on the national and international economies.[364] It is supported not only by common sense, but also by numerous research endeavors that investors, particularly retailers, are unable to protect themselves in securities markets, though their protection is the first and foremost objective of securities regulation, as alluded to earlier. When investors feel they are unprotected, they inevitably lose confidence in both the market integrity and regulatory efficacy.

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[360] *See, e.g.,* TNN, *Rajkot: 25-Year-old Kills Self After Losing Rs 60 Lakh in St*ock Market, THE TIMES OF INDIA, (Mar. 27, 2022), https://timesofindia.indiatimes.com/city/rajkot/25-yr-old-kills-self-after-losing-60l-in-stock-market/articleshow/90467601.cms; *Pathanamthitta Youth Kills Self After Losing Rs 2 Crore In Stock Market* (Mar. 01, 2023), THE MATHRUBHUMI, https://english.mathrubhumi.com/news/kerala/youth-commits-suicide-after-losing-rs-2-crore-in-share-market-1.8353014; Special Correspondent, South Kolkata *Mother Commits Suicide after Son Loses Savings in Share Trading, My Kolkata, India,* https://www.telegraphindia.com/my-kolkata/news/south-kolkata-mother-commits-suicide-after-son-loses-savings-in-share-trading/cid/1863309; PTI, *Youth Commits Suicide after Suffering Losses in Share Market*, THE ECONOMIC TIMES, (Oct. 22, 2008) (India).

[361] Brendan John Lambe, & Tomasz Piotr Wisniewski, *Stock Market Crashes Linked to Higher Rates of Suicide*, THE CONVERSATION, (Sep. 13, 2018), https://theconversation.com/stock-market-crashes-linked-to-higher-rates-of-suicide-new-research-101917 (last visited Oct. 25, 2023) (authors are professors in finance).

[362] Donald C. Langevoort, *Global Securities Regulation after the Financial Crisis*, 13 J. INT'L ECON. L. 799, 815 (2010).

[363] *Id*. at 809.

[364] Kahan, *supra* note 76, at 1035; Morrissey, *supra* note 61, at 648-649; Couture, *supra* note 7, at 368.

Hence, their protection cannot be diluted under any circumstances. My observations and recommendations to fortify that protection are sketched below.

A. Findings

1. Lack of Truth, Inadequacy and Complexity in Disclosures and Its Negative Effect on Making Informed Investment Decisions

A pressing requirement of the disclosure philosophy is the publication of the whole truth in securities. This seems to be an over expectation in the world where corporations' prime, if not their sole, objective is to maximize profits. It has been argued that the fundraising disclosures do not always contain the whole truth, making the disclosed information untrue, defective or misleading. Therefore, the information remains inadequate. Investors' gullibility plays a part in incentivizing corporations to hide the truth and ignore the adequacy requirements. The complexity of financial literature and investors' lack of investment literacy, compounded by corporate culpability, effectively makes informed decisions a myth, rather than a reality.

2. Ambiguities in Materiality of Information and Application of the Reasonable Person Test

The reasonable person test may not always be reasonable or at least may not produce a reasonable outcome in all cases. Whilst this objective test is designed to offer better protection to investors, its inherent subjectivity cannot be completely eliminated. Issuers can claim that they did not believe that reasonable investors would need certain information, allowing them to omit, withhold or inflate a piece of material information They may further claim that, in their opinion, the information was not material, and in effect, a reasonable investor should not expect to find the omitted information in the disclosure and to take into consideration any puffery statement embodied in the disclosure. In court, the judge or jury applies their own interpretation of reasonableness, and thus, a true bystander test does not actually exist in practice. This makes it difficult to judge the materiality of information required to be published pointing to a flaw in the disclosure philosophy itself. mmmm

3. Unreasonably Expecting Investors to Apply a Core Investment Theory of Diversification

Most of the retailers are investment illiterate, or to say more accurately, they lack adequate knowledge to prudently organize their portfolio. Nevertheless, the disclosure philosophy expects them to be prudent in organizing and maintaining their portfolios to avert loss. This expectation is less than realistic because organizing and managing securities portfolio entail an appreciable amount of

knowledge of the significance of different economic sectors, the inherent complexity in the financial taxonomy and an understanding of the fundamentals of issuers etc. However, this cannot be attained automatically.

4. Investors' Cognitive Failings and Behavioral Biases

As argued above, renowned psychologists and behavioral economists have shown that investors have cognitive failings and behavioral biases. They are sometimes unreasonably overconfident about their ability to make appropriate decisions. Evidence has also shown that many of them do not even read the disclosure document at all, and some selectively read the parts they like. All this prompts them to unknowingly make biased investment decisions, ignoring careful estimation of potential risks and potential returns. Avoiding all these fallibilities in practice and minimizing the overoptimism of investors is hard to achieve.

B. Recommendations

1. Adopting a Hybrid Regulatory Policy

This article recognizes the benefit of the disclosure philosophy but agrees with views that the DBR may not be the optimal regulatory philosophy from the viewpoint of investor protection.[365] However, I am not recommending a complete reversal of the DBR; rather, while disclosure must stay in place, a reduction in the current excessive reliance on the disclosed information for retail investor protection warrants a revisit. In other words, the proposed policy reform is a reconciliation or trade-off between the DBR and MBR to strengthen investor protection.[366] To this end, the regulator needs to assess the merits of public offers and the full authority to approve or reject them. The offers with regulatory approval will be allowed to go public after publishing their disclosure documents. To reduce publication costs, only a short form of disclosure[367] may be printed, and the full disclosure needs to be published on the websites of both the issuing company and the regulator. This will introduce a hybrid policy of both merit and disclosure regulation and will not involve any additional costs for anyone. Also, this policy will not infringe on anyone's freedom to make their own decisions in relying on these disclosures, as everyone will be able to carry out their own analysis of the disclosed information. This hybrid policy will benefit the retailers who are unable to assess the disclosure themselves. Furthermore, issuers will be more careful in making a public offer and this may result in a reduction in the total IPOs because the "bad apples" will stay

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[365] Choi & Pritchard, *supra* note 42, at 22; Ripken, *supra* note 11, at 188.

[366] For a discussion of such a reconciliation, *see* Epling & Thompson, *supra* note 114, at 855.

[367] For the contents of different forms of disclosure documents used in Australia (prospectuses, short-form prospectuses, profile statements and offer information statements), *see Corporations Act 2001* (Cth) § 709 (Austl.).

away. This in effect will enhance market integrity and strengthen investor confidence to promote a long-term positive impact on the market. As a matter of principle, eating no egg is better than having a full basket of rotten eggs for consumption. Law and regulation should be concerned with the short-sighted view and preference of investors formed unknowingly because they may not be able to foresee the extent of their eventual detriment, which might appear in the aftermath of the transaction in question.[368]

2. Accepting Paternalism Inherent in Regulation and Regulatory Disclaimer

Paternalistic prohibition exists, even in securities regulation. Issuers under a disclosure regime are not allowed to go public before lodging their disclosure documents with the securities regulator,[369] and both issuers and investors have to wait for the regulator to review and approve.[370] Hawking and advertising for securities are subject to restrictions,[371] a form of paternalism. Paradoxically, the mandated disclosure requirement itself is argued to be a paternalistic approach as it aims to protect investors[372] who "[a]re assumed not to have the sense to insist on the disclosure themselves."[373]

Above all, securities regulators must include a disclaimer in each of the disclosure documents they approve. This disclaimer must state that their approval does not negate all possibilities of making loss by investors because the very nature of the market is unpredictable. Retailers are the liquidity provider. The approval by no means implies any solicitation for buying the offered securities and the regulator does not take any responsibility for investors' decision to subscribe or not to subscribe.

3. Adopting Australian Design and Distribution Obligations with a Recommended Addition

As discussed above, the newly introduced DDOs in Australia have reintroduced merit regulation partially for securities except for fully paid ordinary shares intended to be offered to retail investors. That is applicable to Australia, a developed economy, and its securities markets are dominated by institutional and sophisticated investor. On the other hand, many least developed and developing markets are overly crowded by individual retailers. For example, whilst

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368 *See* Paul Burrows, *Analyzing Legal Paternalism,* 15 INT'L REV. L. & ECON. 489, 497 (1995).
369 *See Securities Act 1933* § 5; Ripken, *supra* note 11, at 11.
370 *See* Hazen, *supra* note 47, at 72-78.
371 Aoun et.al., *supra* note 59, at 894-96.
372 Ripken, *supra* note 11, at 45 (2015) (footnote 248).
373 Edmund W. Kitch, *Proposals for Reform of Securities Regulation,* 41 VA. J. INT'L L. 629, 649 (2001); *See also* Michael D. Guttentag, *Protection from What? Investor Protection and the JOBS Act,* 13 U.C. DAVIS BUS. L.J., 207, 255 (2013).

institutional investors represent only 5-10 percent of total investors, 85-90 percent are individuals in the Bangladesh market.[374] Despite this disparity in investors' demography, these markets also follow the DBR. This article recommends the adoption of merit regulation for all types of securities in the least developed and developing markets, keeping the disclosure requirements unaffected and helping sophisticated investors carry out their own analysis. There are arguments for introducing MBR for all public offerings of securities. [375] Australia has made breaches of DDOs enforceable both civilly and criminally, a trend that can be followed by others.

4. Conferring Product Intervention Powers to Securities Regulators in Line with Australia

PIPs are more critical in markets beyond their developed counterparts. Australia has empowered its securities regulator (ASIC) with PIPs to stop issuing or selling securities to retailers where investment in those financial products will be detrimental to investors. These powers are supported by high level safeguards and accountability mechanisms. Paternalistic actions in securities regulation are aimed to make individuals "better off" than if they were left to make decisions on their own. [376] In a situation where decision-making costs for investors are very high and often irreversible, such as losing of all savings in the investment in an extremely bad offer may not be remedied if the issuer becomes insolvent. However, paternalistic acts can benefit the investing public through a shorter process and a less harmful way.[377] Hence, it is recommended that provisions equivalent to PIPs are introduced in other countries still following the original disclosure philosophy. However, each jurisdiction should pay due regard to their domestic environment in considering the adoption of PIPs with appropriate modifications. The regulatory orders issued under PIPs are legally enforceable and breaches are subject to both civil and criminal liability.

Finally, Professor Ripken's words are important, noting that "[c]are must be taken to ensure that disclosure-based regulation is not idealized simply because we started with a disclosure-based regime, especially if it results in an abdication of substantive responsibility to protect investors and the integrity of the market." [378] Consideration must be given to the fact that people who lack investment knowledge cannot benefit from disclosure when making investment decisions.[379]

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[374] Staff Correspondent, *Protecting Small Investors Is Not Government's Responsibility: Salman F Rahman*, PROTHOM ALO (Bangl.).
[375] Morrissey, *supra* note 61, at 649.
[376] New, *supra* note 34, at 66.
[377] Ripken, *supra* note 11, at 37.
[378] *Id*. at 203.
[379] Uma Shashikant, *Investing Is Complex Because Of Financial Illiteracy or Lack of Trust?* THE ECONOMIC TIME, India, (Mar. 04, 2019). (This point has been argued earlier with emphasis.)

Describing the new reform, the Australian Treasury states that retail investors, like their sophisticated and institutional counterparts, retain the responsibility to make their decision whether to invest or not in a particular offer; however, under the new rules, retail investors get the advantage of regulators' assessment of suitability of the offer to them. The new regime strengthens the accountability of product issuers and distributors.[380]

To summarize, this article opposes neither the innovation of financial products nor the disclosure as a regulatory philosophy. Rather, it solicits for the adoption of a hybrid policy that keeps the disclosure requirements in place. The primary objective of this article is the protection of the investing public, rather than the prevention of financial innovations. Investor protection is fundamental to getting and retaining investors in the market.[381] Revisiting the disclosure philosophy is a need of the time because this philosophy contributed hugely to the occurrence of the GFC. We must not wait for another GFC to hit us before we wake up from the traditional reliance on this philosophy for unsophisticated investors. It may already be too late to prevent the odd from happening as the national and international economies are already strained from the impacts of COVID-19, and the conflicts in Ukraine and Middle East. However, late is better than never.

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[380] FSI Final Report 2014, *supra* note 23, at 198.
[381] Solaiman, *supra* note 9, at 671.