

RESEARCH REPORT

**‘PLEASE EXPLAIN’: ASX
SHARE PRICE QUERIES
AND THE
AUSTRALIAN
CONTINUOUS DISCLOSURE REGIME**

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‘Please Explain’: ASX Share Price Queries and the Australian Continuous Disclosure Regime

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EXECUTIVE SUMMARY

INTRODUCTION

- Recent high profile corporate failures have highlighted the need to re-examine the adequacy of Australian corporate disclosure requirements. Continuous disclosure plays a vital role in the mechanism for information provision to Australian securities markets, and in ensuring that the markets are fair and efficient.
- This Research Report investigates whether particular characteristics in companies may lead to systematic difficulties in compliance with the Australian continuous disclosure regime. The Report draws on a sample of companies identified by Australian Stock Exchange Limited (ASX) as having unexplained trading through the issue of an ASX Price Query, or ‘Please Explain’ in the period from 1 January 1999 to 31 December 2000.

AIM AND SCOPE

- The aim of this Research Report is to examine the level of compliance by listed companies with the Australian continuous disclosure regime. Compliance is investigated using the issue of an ASX Share Price Query (‘Query’) as an indicator of potential non-disclosure.
- For each company queried by ASX, we investigate its characteristics, such as industry and earnings, and, in addition, its disclosure activities subsequent to the Query. This enables us to examine how soon after receipt of a Query material disclosures are made.
- All of the Queries issued by ASX for unusual stock price movements during the 2-year window from 1 January 1999 to 31 December 2000 were examined, giving a total sample of 911 observations.

THE AUSTRALIAN CONTINUOUS DISCLOSURE REGIME

- The Australian continuous disclosure regime is made up of two components: ASX Listing Rule 3.1 and s1001A of the Corporations Act.
- Listing Rule 3.1 (LR 3.1) requires that an entity immediately tell ASX any information concerning it that it becomes aware of, that a ‘reasonable person would expect to have a material effect on the price or value of the entity’s securities.’
- An exception is available if **all** of the three following conditions are met:
 - A reasonable person would not expect the information to be disclosed (LR 3.1.1);
 - The information is confidential (LR 3.1.2); and
 - One or more of the conditions in LR 3.1.3 applies:
 - It would be a breach of law to disclose the information.
 - The information concerns an incomplete proposal or negotiation.
 - The information comprises matters of supposition or is insufficiently definite to warrant disclosure.

- The information is generated for the internal management purposes of the entity.
 - The information is a trade secret.
- Section 1001A was introduced to provide greater penalties for breach of the continuous disclosure provisions as part of a broader enhanced disclosure regime.
- A contravention will occur if an entity has intentionally, recklessly or negligently failed to notify the securities exchange of information that is not generally available and a reasonable person would expect, if it were generally available, to have a material effect on the price or value of listed securities of the entity.

RESULTS

- On average, each company in the sample received two Queries, suggesting that multiple Queries were common. Indeed, one company received ten Queries in the sample period.

Company Characteristics

Industry

- Companies receiving Queries were predominantly from Miscellaneous Industrials (192), Gold (185) and Telecommunications (120) sectors, followed by Other Metals (109) and Healthcare & Biotechnology (69).
 - Within the Miscellaneous Industrials sector, the sub-sectors receiving the most Queries were Computer & Office Services (83) and High Technology (49).
 - Gold Explorers were responsible for 171 of the Queries issued to the Gold sector.
 - Exploration companies were also commonly queried in Other Metals group, with the Mining (Explorer) sub-sector receiving 51 Queries, the highest number in that sector.
 - Equipment, Services (56) and Other Telecommunications (54) received the bulk of the Telecommunications Queries.
 - Biotechnology companies were issued 30 Queries, the most in the Healthcare & Biotechnology industry.

Financial Performance

- Most companies in the sample had negative current earnings (76.65%).

Company Size

- 80.80% of companies issued Queries had a market capitalisation of less than \$100 million.

Information Disclosed With the Query Response

- In 145 of the 911 observations, the Query drove the company to release pertinent information to the market in conjunction with their Query response:
 - 55.17% of these cases released news on the operations of the company.
 - 33.79% included information relating to an acquisition, divestment or agreement.
 - 7.59% of these cases requested a trading halt for the company on receipt of the Query.
- On 487 occasions, the company did not make a major announcement with their response, but included some attempt at explaining the share price movement, mainly in relation to other recent announcements made by the company (59.22%).

Information Disclosed Subsequent to the Query Response

- Companies in the sample were prone to making subsequent announcements in close proximity to the Query.
 - A total of 390 announcements were made on the day following a Query.
 - Of the announcements made on the first day following the Query:
 - 20.3% of these related to news on the company's operations; and
 - 14.1% related to an acquisition, divestment or agreement.
 - Another 412 announcements were made in the two to five day period following the Query. Of these announcements:
 - 18.0% updated the market on operations; and
 - 10.2% released information relating to an acquisition, divestment or agreement.

IMPLICATIONS

- This Research Report highlights a potential lack in candour in disclosure activity. This is demonstrated through the large number of Queries issued during our sample period, the distinct similarities displayed by scrutinised companies, and the time and nature of announcements made by companies subsequent to the Queries.
- Characteristics that may help regulators identify companies with a particular propensity towards non-disclosure are identified:
 - Profitability and size appear to be key indicators.
 - This risk increases where the company belongs to, or is influenced by, the 'new economy' such as the Technology, Biotechnology, Telecommunications and Exploration industries.
- The quality of some company responses to ASX Queries appears to be poor. Some companies do not appear to be answering the questions adequately or providing all of the information that the spirit of the ASX inquiry requires. This could indicate that the formulation of the questions posed by ASX needs to be reconsidered.
- Many companies appear to behave in a reactive rather than proactive fashion in their approach to the continuous disclosure obligations. This is arguably inconsistent with the

continuous disclosure requirements that place the onus on companies to offer information in a timely fashion.

- Many companies appear to regard Listing Rules 3.1.1, 3.1.2 and 3.1.3 as three discrete exceptions rather than *components* of *one* exception. This is not correct, and if clarification is not possible, the company should request a trading halt.
- The results of this Research Report highlight and reinforce the notion already entertained by regulators that continuous disclosure compliance is an area of current concern. Non-disclosure is a very real threat to the efficiency and integrity of Australian markets. Several weaknesses in compliance have been brought to light. Our findings suggest that there may be inherent incentives for non-disclosure, and that there is room for improvement in compliance by listed companies with the Australian continuous disclosure regime.

1 INTRODUCTION

Recent high profile corporate failures have highlighted the need to re-examine the adequacy of Australian corporate disclosure requirements. The continuous disclosure regime, contained in the Listing Rules of Australian Stock Exchange Limited (ASX) and the Corporations Act, plays a key role in the mechanism for information provision to Australian securities markets. 'These disclosure provisions were designed to improve *market fairness* and *market efficiency* by requiring disclosing entities to publish price-sensitive information promptly, thereby assisting all investors to make properly informed decisions about the allocation of their investment funds.'¹

Information provision is a key requirement for the efficient operation of financial markets.² In particular, the timely provision of information allows securities, or more importantly their associated risk, to be priced accurately. This allows for the appropriate distribution of capital throughout the economy.³

In the absence of accurate and timely information, there is a significant risk that investors will make uninformed decisions, to their own detriment. Investors are unlikely to invest in an environment where they believe that they will be exploited by those with better access to information. According to NYSE Chairman, Richard A Grasso, 'a higher level of disclosure ... helps investors overcome distrust and assists international capital flows.'⁴

Despite its clear importance, there is a question as to whether adequate incentives exist for the markets to voluntarily provide sufficient information.⁵ The arguments in favour of mandatory disclosure include the role of disclosure as a public good, reduction of agency costs and investor protection.⁶ In addition, an efficient disclosure system should result in a reduction in a company's cost of capital and an increase in allocative efficiency, and consequently an increase in shareholder wealth.⁷ The view of the Australian government at the time of the introduction of the continuous disclosure regime was that 'a well informed

¹ Companies and Securities Advisory Committee (CASAC), *Insider Trading: Discussion Paper* (June 2001), paragraph 2.63.

² Robert Pindyck and Daniel Rubenfield, *Microeconomics* (2nd ed, 1992) 604; Eugene F. Fama, 'Efficient Capital Markets: A Review of Theory and Empirical Work' (1970) 25 *Journal of Finance* 383.

³ See, eg, Marcel Kahan, 'Securities Law and the Social Costs of Inaccurate Stock Prices' (1992) 41 *Duke Law Journal* 977, 979; John C. Coffee Jr., 'Market Failure and the Economic Case for a Mandatory Disclosure System' (1984) 70 *Virginia Law Review* 717, 719-20.

⁴ New York Stock Exchange Speech, Richard A Grasso, 'Equity Market Globalization: A View from 11 Wall Street' <<http://www.nyse.com/speech/NT00018B5A.html>> at 23 October 2000 (copy on file with authors).

⁵ See, eg, Christopher J.H. Donald, 'A Critique of Arguments for Mandatory Continuous Disclosure' (1999) 62 *Saskatchewan Law Review* 85; Dale Arthur Oesterle, 'The Inexorable March Towards a Continuous Disclosure Requirement for Publicly Traded Corporations: 'Are We There Yet?'' (1998) 20 *Cardozo Law Review* 135.

⁶ Mark Blair and Ian M. Ramsay, 'Mandatory Corporate Disclosure Rules and Securities Regulation' in G Walker, B Fisse and I Ramsay (eds), *Securities Regulation in Australia and New Zealand* (2nd ed, 1998) 55-87.

⁷ Oesterle, above n 5, 195-6.

market leads to greater investor confidence and in turn a greater willingness to invest in Australian business.’⁸

The existence of both stock market based and legislative requirements for disclosure by listed companies in Australia is well established. The Australian continuous disclosure framework broadly requires companies to disclose immediately to ASX information that would have a material effect on their share price if released.

Compliance with the regime has recently been the subject of increasing concern, particularly with growing direct retail investment on ASX. This has created a new class of investors who are regarded by regulators as needing greater protection than professional or more experienced private investors.⁹ ASX has stated that it is also concerned about the level of disclosure by the large number of new companies listing on ASX, the directors of whom often have limited experience in the management of listed companies.¹⁰ ASIC has identified mining companies and newly listed technology companies as being most at risk of non-disclosure.¹¹

While there has been substantial research on the theoretical need for information in capital markets and also the cost of non-disclosure, there has been little empirical work on non-compliance with disclosure regimes. A better understanding of this issue could greatly assist in the effective implementation of continuous disclosure policies by providing an analysis of the behaviour and characteristics of non-disclosing entities, thereby identifying potential ‘trouble spots’ in the existing regime.

This Research Report investigates whether particular behavioural or company characteristics may lead to systematic difficulties in compliance with the Australian continuous disclosure regime. The sample is based on companies identified by ASX as having unexplained trading through the issue of an ASX Price Query, colloquially known as a ‘Please Explain’ in the period from 1 January 1999 to 31 December 2000. Use of a ‘Price Query’ based sample is particularly pertinent in light of the recent ASIC and ASX statements that ‘a pattern is emerging where the unexplained price and volume movements continue for a fortnight or so, only to be brought to an end by the release of information to the market by the company.’¹²

⁸ Senator N. Bolkus, Second Reading Speech, *Corporate Law Reform Bill (No 2) 1992*, 26 November 1992.

⁹ ASIC Media Release MR 00/365, ‘ASIC and ASX join forces for better disclosure by listed companies’, 23/8/2000. Note the distinction in s708 of the Corporations Act with regard to *sophisticated investors*. Section 708 provides for offers of securities that do not need disclosure under s 706 of the Ch 6D fundraising provisions, and includes exemptions for investors considered to be sophisticated as a result of their level of wealth, the size of the investment they are making or their investment experience.

¹⁰ Alan Cameron AM, ‘The Effect of Harmonisation on the Regulator and Regulation’, Address at a Committee for the Economic Development of Australia (CEDA) seminar, *CLERP 6 - Government’s Blueprint for a Single Regulatory Regime*, 11 February 2000.

¹¹ Eleanor Hor-Kwong (ed), ‘High tech disclosure must improve’, *ASIC News, Issue 29* (October 2000); ASIC Media Release MR 00/379, ‘High tech disclosure not what it should be’ 4/9/2000.

¹² Cameron, above n 10.

The use of ASX issued Queries as a proxy for nondisclosure is, however, subject to limitations. To the extent that ASX dealt with the issue other than through the issue of a Query, instances of nondisclosure may have been missed by our sample. In addition, nondisclosure may exist without an unexplained price movement where the undisclosed information is not subject to trading. Finally, not all unexplained price movements are necessarily a result of nondisclosure.

Section two examines the rationale behind the continuous disclosure regime; section three describes the Australian regulatory environment for continuous disclosure; section four explains the methodology underlying our study; section five presents the results and section six outlines the policy implications arising from this investigation.

2 WHY DO WE NEED CONTINUOUS DISCLOSURE?

2.1 INTRODUCTION

This section sets out the theoretical justifications for mandatory disclosure, particularly in the context of information as an economic good, in order to provide investor protection, and, amongst other things, to protect against insider trading. As a final point, it briefly discusses the changing nature of information provision in the Internet age.

2.2 MANDATORY DISCLOSURE

Mandatory disclosure describes the intervention by the government to compel companies to disclose information, be it financial or operational. Disclosure usually takes one of two key forms - periodic, where companies must provide information to the market at regular fixed intervals, or continuous, where companies must provide information to the market as it arises. The Australian regime captures characteristics of both these systems. This Research Report focuses on the continuous disclosure regime.

The need for a mandatory disclosure regime has been the subject of considerable theoretical debate.¹³ Economic theory suggests that a government should only intervene if a distinct market failure is identified. For example, government intervention may be required in order to provide a public good that would not otherwise be provided, or to prevent externalities that would otherwise occur.

A public good is distinguished by two characteristics: that consumption by one person does not reduce the total supply, and that providers of the good cannot exclude people who have not paid from using it. It is well established in the economic literature that where a public good is provided by the private sector, its value may not be fully recognised by the producer.

In the market for information, market failure is said to arise due to the status of disclosure as a public good, and companies' consequent failure to attribute the true value of information to investors.¹⁴ It has been suggested that there may be an incentive not to disclose as competitors may then free ride on the industry and company specific information to gain a competitive advantage.¹⁵

¹³ Blair and Ramsay, above n 6, 266.

¹⁴ Oesterle, above n 5; Coffee, above n 3; Stephen Bainbridge, 'Thirteen Annual Corporation Law Symposium: Contemporary Issues in the Law of Business Organizations: Mandatory Disclosure: A Behavioral Analysis' (2000) 68 *University of Cincinnati Law Review* 1023.

¹⁵ Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* (1991), 290-291.

Overinvestment in or duplication of research by investors¹⁶ resulting in ‘social waste’¹⁷ is also cited as a source of possible market failure, and therefore a motivation for mandatory disclosure. This is based on the premise that in certain conditions, investors may ‘expend resources to pursue trading gains without adding to shareholder wealth.’¹⁸ In the case of securities trading, each rational trader conducts research with the intention of increasing the accuracy of their valuation of the particular security, and consequently reducing the risk of an inappropriate investment. Overinvestment, particularly in areas such as basic financial and operational results, arises due to a lack of basic information in the market. Mandatory disclosure, it is argued, eliminates the need for much of the ‘core’ research, and increases the incentives to conduct strategic and value-adding research that contributes to the market’s understanding of a security.

Information asymmetry between management and investors as a result of a lack of mandatory disclosure and the resulting agency costs, has also been discussed as a possible cause of market failure.¹⁹ Mahoney suggests that the reduction of agency costs is and ought to be the law’s primary purpose.²⁰ Mandatory disclosure increases the available information regarding management’s decisions and therefore theoretically reduces the likelihood of misuse of assets.²¹ A contrary view is that full and instantaneous disclosure of all matters, whether commercially settled or not, may compromise a company’s business decision at sensitive points in its development.²²

Finally, the ‘lemon effect’ has also been raised as a potential source of market failure. The concept was first developed in the economic literature by Akerloff with regard to the used car market.²³ It describes the situation where investors discount the value of all securities due to their inability to distinguish the ‘good’ investments from the ‘bad’. Oesterle claims that this factor is underappreciated in securities market regulation.²⁴ The importance of sentiment and reputation was clearly highlighted by the outflow of capital following the collapse of a number of Asian economies in the Asian crisis of 1997. As stated by ASIC in its guidance and discussion paper on continuous disclosure, ‘[t]he market cannot operate effectively

¹⁶ Oesterle, above n 5, 201-2.

¹⁷ Blair and Ramsay, above n 6, 268-9.

¹⁸ Jack Hirshleifer, ‘The Private and Social Value of Information and the Reward to Inventive Activity’ (1971) 61 *American Economic Review* 561 as discussed in Oesterle, above n 5, 201.

¹⁹ Oesterle, above n 5, 206-7; Blair and Ramsay, above n 6, 269-70.

²⁰ Paul G. Mahoney, ‘Mandatory Disclosure as a Solution to Agency Problems’ (1995) 62 *University of Chicago Law Review* 1047.

²¹ However, in this context, it must be noted that periodic disclosure would be insufficient to provide genuine monitoring of management. Only through continuous disclosure could management decisions be effectively monitored.

²² See Section 4 of this Research Report for a discussion of how this issue is addressed in ASX Listing Rules.

²³ George Akerloff, ‘The Market for ‘Lemons’: Qualitative Uncertainty and the Market Mechanism’ (1970) 84 *Quarterly Journal of Economics* 488; Oesterle, above n 5, 208-211.

²⁴ Oesterle, above n 5, 208.

without public confidence in its integrity...That is the purpose of the continuous disclosure requirements.²⁵

For each of the market failures traditionally attributed to lack of mandatory disclosure, it has also been suggested either that these failures could be solved through a market-based solution, or that mandatory disclosure will not resolve the problem.²⁶ This view builds on the work by Stigler and Benston in the late 1960s, where the authors claimed that market forces would produce the optimal level of disclosure. Their conclusions were based on a study of the disclosure practices prior to, and immediately following the enactment of the US mandatory disclosure legislation in 1934.²⁷

The need for mandatory disclosure has been further questioned following the results of studies by Ross,²⁸ Grossman²⁹ and Milgrom.³⁰ The authors in these studies used various economic models to show that ‘true’ information is valuable to market participants, and consequently a lack of disclosure is interpreted by the market as ‘bad’ news. This suggests that a lack of disclosure in itself provides information to the market about a company’s prospects. If the act of nondisclosure provides information, the argument follows that there is no need to mandate information provision through disclosure regulation.

These arguments both for and against mandatory disclosure are discussed extensively in the literature.³¹ This Research Paper, however, concentrates on the role of mandatory disclosure as a mechanism for investor protection, a focus of the Australian legislative regime.

2.3 MANDATORY DISCLOSURE AND INVESTOR PROTECTION

The impact of mandatory disclosure has been found to be particularly beneficial in markets where there is a combination of informed and uninformed participants, as the informed customers ‘convey information about product quality to the uninformed’³² through, for

²⁵ ‘Heard it on the Grapevine...Disclosure of Information to Investors and Compliance with Continuous Disclosure and Insider Trading Provisions’ *Draft ASIC guidance and discussion paper* (November 1999) 7.

²⁶ Donald, above n 5, 86.

²⁷ George J. Stigler, ‘Public Regulation of the Securities Markets’ (1964) 37 *Journal of Business* 117, 120-24; George J. Benston, ‘The Value of the SEC’s Accounting Disclosure Requirements’ (1969) 44 *Accounting Review* 515; both discussed in Oesterle, above n 5, 195.

²⁸ Stephen A. Ross, ‘Disclosure Regulation in Financial Markets: Implications of Modern Finance Theory and Signalling Theory’ *Issues in Financial Regulation* (1979) as discussed in Anat R. Admati and Paul Pfleiderer, ‘Forcing Firms to Talk: Financial Disclosure Regulation and Externalities’ (Working Paper, Graduate School of Business, Stanford University, 1998).

²⁹ Sanford J. Grossman, ‘The Informational Role of Warranties and Private Disclosure About Product Quality’ (1981) 24 *Journal of Law and Economics* 46.

³⁰ Paul R. Milgrom, ‘Good News and Bad News: Representation Theorems and Applications’ (1981) 12 *Bell Journal of Economics* 380.

³¹ See, eg, Oesterle, above n 5; Blair and Ramsay, above n 6 and Donald, above n 5.

³² Michael J. Fishman and Kathleen M. Hagerty, ‘Mandatory vs. Voluntary Disclosure in Markets with Informed and Uninformed Customers’ (Working Paper, Kellogg Graduate School of Management, Northwestern University, 1997) 3.

example, their trading patterns. Using an economic model, Fishman and Hagerty³³ find that where disclosure is not mandatory and becoming informed is costly, there will be fewer informed customers in the market than is socially optimal. Indeed, one of the possible equilibria found by the authors is for no customers to become informed at all. Further, in the absence of an obligation to disclose information, there is a substantially higher risk of ‘market failure associated with private production of securities information.’³⁴ Mandatory disclosure is argued to remedy these defects.

Without a mandatory disclosure system, there may be an incentive to conceal or misrepresent material information.³⁵ This is supported by the findings of Hughes and Sankar, who document that disclosure by companies varies with the expected cost of litigation. If expected litigation costs are small, then management will only disclose good news, while if the expected litigation costs are large, disclosures are biased towards bad news.³⁶ A legislative disclosure regime can provide the environment where companies will disclose both good and bad information equally promptly, ensuring that management statements are credible and can be used in the investment decision.³⁷

Rather than impose a broad mandatory disclosure regime, Bainbridge argues that the need for ‘credibility’ could also be achieved through anti-fraud provisions, and expanded liability for nondisclosures.³⁸ However, while this may be sufficient for a large liquid capital market, where the volume of trading can in itself provide information, the smaller the market, and arguably the smaller and more illiquid the security, this argument becomes less relevant. With smaller securities, there are likely to be fewer alternative sources of information, and the cost of information acquisition and processing for investor is likely to be greater. In this instance, it can be argued that mandatory disclosure is required to ensure that relevant information reaches the market, and market efficiency is not undermined.

In a study of shareholder returns prior to and immediately following the introduction of mandatory disclosure in the US market, no change in shareholder returns on the NYSE³⁹ was found following the introduction of mandatory disclosure. Yet there was a substantial increase in returns for initial public offers on US regional exchanges.⁴⁰ This suggests that mandatory disclosure is critical in markets which may not have sufficient capital flows to ‘force’ full disclosure.

³³ Above n 32.

³⁴ Blair and Ramsay, above n 6, 266.

³⁵ Joel Seligman, ‘The Historical Need for a Mandatory Corporate Disclosure System’ (1979) 9 *Journal of Corporate Law* 1, 9.

³⁶ P.J. Hughes and M.R. Sankar, ‘The Impact of Litigation Risk on Discretionary Disclosure’ (Working Paper, University of California, 1997).

³⁷ Bainbridge, above n 14, 8-9.

³⁸ Bainbridge, above n 14, 9.

³⁹ New York Stock Exchange.

⁴⁰ Carol Simon, ‘The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues’ (1989) 79 *American Economic Review* 295.

2.4 CONTINUOUS DISCLOSURE AND INSIDER TRADING

One of the key motivations for the Australian continuous disclosure regime is to assist in the prohibition against insider trading⁴¹ - the desire to ensure that informed investors do not use their 'private' information to take advantage of the wider market.⁴² Intentions of timely disclosure include to 'reduce the opportunities for insider trading as well as counter the creation of false markets or the distortion of markets through dissemination of rumours or false information.'⁴³ While certain authors believe that insider trading is key to the proliferation of private information through the market,⁴⁴ there is substantial evidence that it results in positive abnormal returns for insiders, and a resulting negative return for the uninformed traders on the other side of the transaction.⁴⁵ These studies also establish that an uninformed trader can generate positive abnormal returns by mimicking the trades of insiders.

By legislating against insider trading, the government is making a policy decision to protect an ever-growing pool of investors.⁴⁶ The Companies and Securities Advisory Committee (CASAC) recently noted that there 'is a strong community view that insider trading is reprehensible and should be prosecuted. Increasing levels of share ownership and market participation in Australia have heightened this general community expectation.'⁴⁷ ASIC has clearly stated that it believes that investor confidence and market integrity rely on 'equal and timely access to price sensitive information.'⁴⁸ CASAC⁴⁹ also noted, however, that insider trading laws should be 'clear and workable', and should not unreasonably restrict or discourage legitimate research, contributing to efficient markets.

In his discussion of insider trading enforcement, Gething examines the link between continuous disclosure and insider trading.⁵⁰ He states that the development of the prohibition against insider trading is based on the unfair advantage theory, or that inequality of

⁴¹ Section 1002G of the *Corporations Act*.

⁴² ASIC, above n 25, 4.

⁴³ Companies and Securities Advisory Committee (CASAC), *Report on an Enhanced Statutory Disclosure System* (September 1991), 7, as discussed in Companies and Securities Advisory Committee (CASAC), *Insider Trading: Discussion Paper* (June 2001), paragraph 2.63.

⁴⁴ Stigler and Benston, above n 27.

⁴⁵ See, eg. H. Nejat Seyhun, 'Insiders' Profits, Costs of Trading, and Market Efficiency' (1986) 16 *Journal of Financial Economics* 189; J.F. Jaffe, 'Special Information and Insider Trading' (1974) 47 *Journal of Business* 410; J.E. Finnerty, 'Insiders and Market Efficiency' (1976) 31 *Journal of Finance* 1141.

⁴⁶ Note that Australia has the highest level of share ownership in the world with 54% of Australians owning shares, either directly or indirectly: Australian Stock Exchange Limited, *2000 Australian Share Ownership Study*, 28 September 2000.

⁴⁷ Companies and Securities Advisory Committee, above n 43, paragraph 0.3.

⁴⁸ Cameron, above n 42, 4.

⁴⁹ Above n 43, paragraphs 0.4-0.5.

⁵⁰ Michael Gething, 'Insider Trading Enforcement: Where are We Now and Where Do We Go From Here?' (1998) 16 *Company and Securities Law Journal* 607.

information is only prohibited if the advantage gained is inequitable.⁵¹ The mere possession of insider information is not in and of itself illegal.

In the context of preventing insider trading from occurring, it becomes increasingly critical to address the way in which information is provided to the market. If all material information is ‘immediately’ disclosed to ASX and released to the market, then one trader would be unable to use ‘undisclosed price sensitive information to take advantage of another.’⁵²

However, insider trading provisions are notoriously difficult to prosecute given the problems inherent in detection- proving that the trader possessed information that falls within the definition of ‘not generally available’, and proving that the information is material.⁵³ Given the small number of prosecutions for insider trading in the Australian market, it is important to focus on the formulation and implementation of an effective continuous disclosure regime to remove the ‘opportunity’.

2.5 INFORMATION DISSEMINATION AND THE INTERNET

Technological change has also had a substantial impact on both the dissemination of information to the market and the market itself. As noted by John C. Coffee Jr.:

The introduction of the telegraph and the telephone profoundly changed the character of the securities market, increasing the speed with which information could reach the market and the accessibility of investors to issuer communications. But an indirect result was to increase the informational advantage possessed by the professional trader over the average trader.⁵⁴

The Internet, as a new mechanism for information dissemination, has significant consequences for disclosure policy. The Internet has changed the speed, nature of and access to information provision. The instantaneous nature of information flows in modern markets, along with the potentially limitless audience, highlights the importance of establishing adequate controls over quality and content.

The Internet has also had a dramatic impact on the ability of small, retail investors to trade ‘instantaneously’ through Internet brokers. Indeed, access to cheap brokerage has coincided with a dramatic increase in trading by retail investors as evidenced by the increasing market

⁵¹ Gething, above n 50, 608-9.

⁵² Gething, above n 50, 620.

⁵³ A discussion of the effectiveness of insider trading provisions is beyond the scope of this Report. See, eg, Gething, above n 50, 618-9; J. Carr Bettis, William A. Duncan and W. Ken Harmon, ‘The Effectiveness of Insider Trading Regulations’ (1998) 14 *Journal of Applied Business Research* 53.

⁵⁴ John C. Coffee Jr., ‘Brave New World?: The Impact(s) of the Internet on Modern Securities Regulation’ (1997) 52 *Business Lawyer* 1195, 1195.

share of e-brokers. As at November 1999, online broking represented approximately 25% of the broking market share in the US and 16% in Australia.⁵⁵

The impact of the Internet on information provision practices has been startling in the Australian environment. Many companies now have websites where they publish all financial and other results. Many also provide all press releases and broker presentations. This has dramatically increased the information available to non-professional investors, who previously only had access to periodic reporting and such news that was reported through the press. ASIC now encourages companies to publish all information provided during a broker briefing on their websites, even down to the transcript of questions and responses.⁵⁶

However, the speed with which information can now be provided has increased the possibility of misleading information reaching the market. In July 1999, ASIC successfully prosecuted a person from Victoria for disseminating information that was false and misleading on the internet (through email) that was likely to induce the purchase of a security listed on NASDAQ.⁵⁷ Actions by unlicensed brokers have also been a focus of ASIC investigation.⁵⁸ For example, a website called 'The Chimes' offered investors the opportunity to purchase shares in the AMP demutualisation at a predetermined price before the float, and a Federal Court ruling was required to remove the offending parts of the website.⁵⁹

In addition, ASIC has released an interim policy statement for internet discussion sites following increasing concerns that the sites are being used to used to 'manipulate the market, trade on inside information or take advantage of less well informed investors.'⁶⁰ ASIC's policy is that a license should not be needed to run a site that only facilitates contact between investors, but only if the site is not likely to mislead investors by suggesting that it is a source of professional advice.

These examples highlight the risk associated with information provision on the Internet. The speed of this medium allows information to be passed very quickly, often before its accuracy can be confirmed.⁶¹ The importance of an effective continuous disclosure regime is amplified in an environment where any information flows so quickly through the market.

⁵⁵ Will Corkill, 'Online Broking and E*Trade - a Look at Online Broking in the US and the State of Play in Australia' *Macquarie Equities Research Report* (November 1999).

⁵⁶ ASIC, above n 25.

⁵⁷ ASIC Media Release MR 00/306, 'Internet 'Spammer' pleads guilty to ASIC charges' 14/7/2000.

⁵⁸ Joseph P. Longo, 'Cyber Enforcement in the Financial Services Sector' *Speech - ACCC's Global Commerce Conference, Sydney 9 November 1998, ASIC Digest SPCH 33*, 33.12.

⁵⁹ Longo, above n 58, 33.17.

⁶⁰ ASIC Media Release MR 00/348 'ASIC releases interim policy for internet discussion sites' 15/8/2000.

⁶¹ See also John Davidson, 'Hoax news sends Emulex into a \$4.4bn fall' *The Australian Financial Reviews*, 28 August 2000, 25.

3 THE AUSTRALIAN CONTINUOUS DISCLOSURE REGIME

‘The government considers it essential that there be timely disclosure of relevant information about the financial position and prospect of entities in which Australians invest. It is essential to enable informed judgements on investment decisions whether made by individual Australians or by large institutional investors...to ensure an equitable and efficient investment system.’⁶²

The Australian continuous disclosure regime is made up of two components: ASX Listing Rule 3.1 and s1001A of the Corporations Act.⁶³

3.1 LISTING RULE 3.1

The introduction to the ASX Listing Rules contains a set of principles upon which the rules are based. The fifth rule states that ‘[t]imely disclosure must be made of information which may affect security values or influence investment decisions, and information in which security holders, investors and ASX have a legitimate interest.’

Chapter 3 of the Listing Rules (LR) sets out the continuous disclosure requirements that must be met by all listed companies on ASX, in addition to other disclosure requirements that exist in Chapters 4, 5 and 15 which deal respectively with periodic disclosure, additional reporting requirements for specific entities, including mining entities and timing requirements for lodging draft and final documents.

Listing Rule 3.1 (LR 3.1) requires that an entity immediately tell ASX any information concerning it that it becomes aware of, that a ‘reasonable person would expect to have a material effect on the price or value of the entity’s securities.’⁶⁴ Under LR 15.6, the entity must not release this information to any person until ASX has released the information to the market, except where the release becomes available outside of the hours of operation of the company announcements office of ASX, or it is required to be released by an overseas exchange.

The operation of LR 3.1 is subject to an exception if each of the conditions in LR 3.1.1, LR 3.1.2 and LR 3.1.3 is met. The conditions are that:

- 3.1.1 A reasonable person would not expect the information to be disclosed.
- 3.1.2 The information is confidential.
- 3.1.3 One or more of the following applies.

⁶² Senator Nick Bolkus, Second Reading Speech, *Corporate Law Reform Bill (No 2) 1992*, 26 November 1992.

⁶³ All references to sections are of the Corporations Act, except as otherwise specified.

⁶⁴ ASX Listing Rule 3.1.

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

ASX provides examples of the types of information that would require disclosure under Listing Rule 3.1.⁶⁵ These include an acquisition where the consideration is material relative to the written down value of the company, the results of a security issue, any transaction with a related party, a settlement of litigation, even if the terms of settlement are confidential, and a signing of a formal contract, even if it is conditional on financing being secured.

The interpretation of this Rule is of great concern to companies, given that it is often commercially necessary to maintain confidentiality regarding ‘material’ matters. However, in the interests of fair trading, ASX has stated that it will ‘give weight to judgements that are logically and honestly made’ in the enforcement of LR 3.1.⁶⁶ The continuous disclosure regime must ‘not be interpreted in a restrictive or legalistic fashion’ so as to enhance the credibility of the market.⁶⁷

3.1.1 *Aware*

The definition of ‘aware’ is contained in LR 19.2. An entity becomes aware of information if a director or executive officer ‘has or ought reasonably to have come into possession of the information’ in the course of performance of their employment duties. This definition is based on the test for the insider trading provisions in s1002E, but it excludes knowledge of employees generally.

Given that the awareness test is still quite broad, it is critical that companies have systems in place to ensure that information that ‘ought’ to be in the possession of the directors and executive officers is actually available.⁶⁸ Practically, companies may not have disclosure ‘systems’ in place, particularly those that are smaller.⁶⁹ Assistance in the provision of disclosure systems was one of the motivations for the ASIC draft guidance and discussion paper, ‘Heard it on the Grapevine...’.⁷⁰

⁶⁵ See, eg, ‘Continuous disclosure: Listing Rule 3.1’ *ASX Guidance Note*.

⁶⁶ ASX Guidance Note, above n 65, paragraph 3.

⁶⁷ Listing Rule 19.2 and ASX Guidance Note, above n 65, 26-27.

⁶⁸ ASX Guidance Note, above n 65, paragraph 5 - 6.

⁶⁹ ASIC, above n 25.

⁷⁰ Above n 25.

3.1.2 Material Information

Under LR 19.3, if a definition for a term is not contained in the Listing Rules, then the *Corporations Act* should be used to interpret the term. *Material* is not defined in the Listing Rules, but under s1001D, a reasonable person ‘would be taken to expect information to have a material effect on the price or value of securities if the information would, or would be likely to, influence persons who commonly invest in securities in deciding whether or not to subscribe for, or buy or sell’ the securities.

Information is not defined in the Listing Rules or the *Corporations Act*, however it is likely to be broader than factual knowledge.⁷¹ It may include rumours or speculation if they are material to the price or value of the security, or if they are sufficiently certain to be reported.⁷² However, unlike the insider trading provisions, arguably it would not include matters of supposition unless it dealt with information about specified events.⁷³

The information to be disclosed is information concerning the entity. Widely available information, such as a commodity price, does not generally need to be specifically disclosed. However, any specific effects or consequences of this generally known information must be disclosed to the market.⁷⁴

3.1.3 Influence

A decision concerning what information is likely to ‘influence’ people is highly fact specific, and depends on the prevailing circumstances.⁷⁵ It has been said that it is not necessary for the information to ‘alter’ the investment decision.⁷⁶ The ASX Guidance Note states that a company must make all disclosures necessary to prevent a false market, and consequently may be required to confirm or deny a rumour.⁷⁷ This is particularly relevant for our sample, given the high interest in the ‘new economy’ at that time, and the predominance of ‘dot.com’ rumours regarding a company’s operations. In the opinion of many commentators, this caused unrealistic valuations.⁷⁸

⁷¹ Gething, above n 50, 621.

⁷² See, eg, *Commissioner for Corporate Affairs v Green* [1978] VR 505, 511 per McInerney J; *Hooker Investments Pty Ltd v Baring Bros Halkerston & Partners Securities Ltd* (1986) 10 ACLR 462, 468 per Young J. These cases are discussed in W. J. Koeck, ‘Continuous Disclosure’ (1995) 13 *Company and Securities Law Journal* 485.

⁷³ *Explanatory Memorandum to the Corporate Law Reform Bill 1993 (Cth)* paragraph 250; *Ryan v Triguboff* (1976) 1 NSWLR 588, 596 - 597; as discussed in Koeck, above n 72, 496.

⁷⁴ ASX Guidance Note, above n 68, paragraph 13; Koeck, above n 72, 494.

⁷⁵ *Flavel v Roget* (1990) 1 ACSR 595, 602-3, per O’Loughlin J.

⁷⁶ Koeck, above n 72, 486.

⁷⁷ ASX Guidance Note, above n 65, paragraph 10.

⁷⁸ See, eg, Stephen Romei, ‘Fools and their money’ *The Australian*, 23 December 1999, 26.

3.1.4 *Immediately*

Immediately is also not defined in the Listing Rules or the Corporations Act. The term has been interpreted by the courts as being highly fact specific.⁷⁹ In the context of continuous disclosure, Koeck states that ‘immediately’ would require the company officer to put aside what they are doing on hearing something that *may* require disclosure to consider whether disclosure is appropriate. If so, the disclosure must be made as quickly as possible so as to minimise the risk of insider trading occurring while the information remains undisclosed. If it is outside of trading hours, then disclosure must occur prior to the next commencement of trading.⁸⁰ In the absence of ‘immediate’ disclosure, LR 17.1 requires a company to request a trading halt.

3.1.5 *Exceptions*

As stated above, the exception to LR 3.1 contains 3 conditions, *all* of which must be satisfied for the exception to hold. That is, a reasonable person would not expect the information to be disclosed, the information is confidential, and one or more of the requirements in Listing Rule 3.1.3 is satisfied.

Under LR 3.1.1, a reasonable person would not expect the information to be disclosed if the result were to unreasonably prejudice the entity. By the same token, LR 3.1 does not require disclosure of an inordinate amount of detail.⁸¹ Even if the information falls within a category listed in LR 3.1.3, if that information becomes known to a market participant, then it no longer meets the confidentiality requirement in LR 3.1.2 and must be disclosed to ASX. ASIC has recently announced that it believes that information selectively disclosed to an analyst or other outsider will no longer be confidential for the purpose of LR 3.1.2.⁸² Entering into a confidentiality agreement will not be sufficient to satisfy LR 3.1.2.⁸³

Similarly, even if confidentiality were maintained and the information fell within the categories in LR 3.1.3, the company would still have to disclose the information if a reasonable person would expect it to be disclosed.

3.1.6 *Non-compliance with the Listing Rules*

If a company does not comply with the Listing Rules, ASX can suspend or de-list the company in question. While ASX does have standing to take court action to force compliance with the Listing Rules under s777 or s1114, ASX has never taken action under these sections.

⁷⁹ Koeck, above n 72, 503; *Wightman v Sand Board of Canterbury & Quirk* (1912) 31 NZLR 799, 806, per Denniston J.

⁸⁰ Koeck, above n 72, 502-503.

⁸¹ ASX Guidance Note, above n 65, 14.

⁸² ASIC, above n 25, 25.

However, enforcement of the continuous disclosure obligations is specifically addressed in s1001A.

3.2 SECTION 1001A, CORPORATIONS ACT

Section 1001A was introduced to provide greater penalties for breach of the continuous disclosure provisions as part of a broader enhanced disclosure regime.⁸⁴ A contravention will occur if an entity has intentionally, recklessly or negligently failed to notify the securities exchange of information that is not generally available and a reasonable person would expect, if it were generally available, to have a material effect on the price or value of listed securities of the entity.

LR 3.1 imposes an obligation to disclose information to ASX, even if it is generally available. In particular, ASX requires the company to disclose any company specific effects that arise from that information. In contrast, s1001A does not require additional disclosure of generally available information.

The primary contribution of s1001A to the continuous disclosure provisions in the Listing Rules is the imposition of criminal liability for intentional or reckless contraventions and civil liability for negligent contravention. It is the failure to notify rather than the breach of the section itself that must be intentional, reckless or negligent.⁸⁵ Not only is the entity subject to this section, but persons who are 'involved in' the contravention can also be subject to both criminal and civil liability under s1005.

Despite this increased power, and the large number of price queries issued by ASX, there have been no prosecutions for breach of s1001A since its introduction.⁸⁶ Gething discusses the difficulties of enforcement of a negligent contravention of the section as there is no penalty, civil or criminal, for this contravention.⁸⁷ He suggests that a possible solution would be to commence civil proceedings seeking a declaration that a company has acted negligently and an order under s1114 requiring a compliance program to be adopted. This is consistent with the enforceable undertakings that ASIC has extracted from a number of companies following breaches of the continuous disclosure regime.⁸⁸

⁸³ ASX Guidance Note, above n 65, 20.

⁸⁴ *Corporate Law Reform Act 1994* (Cth), s 4.

⁸⁵ Gething, above n 50, 623.

⁸⁶ ASIC has, however, recently obtained additional disclosure from several companies through discussions: see, eg, ASIC Media Release MR 01/284, 'ASIC Cracks Down on Continuous Disclosure', 13/8/2001; ASIC Media Release MR 01/347 'ASIC Obtains Better Disclosure by Listed Companies', 26/9/2001.

⁸⁷ Gething, above n 50, 626.

⁸⁸ Enforceable undertakings with regard to their disclosure practices were extracted from the following companies in 1998: West Oil NL, MRI Holdings and Crown Ltd.

3.3 ASX AND ASIC CONTINUOUS DISCLOSURE PROGRAM

In February 2000 ASX and ASIC announced an expanded surveillance program of compliance with the continuous disclosure obligations under both LR 3.1 and s1001A. Based in Perth and Brisbane, the program targeted companies in the technology and mining sectors which have delayed releasing price sensitive information, 'which would have the effect of increasing the price of the companies' shares.'⁸⁹

The program saw a marked decrease in the number of price query letters being sent out in April by ASX in Perth and Brisbane in response to unexplained movements in price and volume.⁹⁰ There was also an increase in the number of trading halts requested by companies. ASIC has suggested that, as a result of the program, companies are also more cognisant of their obligation to halt trading if they cannot make full disclosure to the market,⁹¹ citing that requests for trading halts in Perth had 'more than doubled' during February and March as compared to the beginning of the year. However, in the Schedule to a later Media Release,⁹² results of the program show that the number of trading halts requested in Perth during April more than halved⁹³ as compared to March. Indeed, only one trading halt was requested in Brisbane during the month.

While no civil action was taken by ASIC in this initial investigation, extensive negotiations were necessary with a number of companies in order to achieve what ASIC felt was the appropriate level of disclosure.⁹⁴ The success of this initial targeted program supports the assertion that enforcement of the continuous disclosure obligations using various company characteristics has improved the overall level of market disclosure. ASIC has stated that it intends to expand the program to include timely disclosure of all news, good and bad.⁹⁵

⁸⁹ 'ASIC puts technology companies under the disclosure microscope' *ASIC Media Release MR 00/268*, 22 June 2000.

⁹⁰ ASIC Media Release, above n 89.

⁹¹ ASIC Media Release MR 00/163, 'Listed Companies Lift Their Game' 12/4/2000.

⁹² ASIC Media Release, above n 89.

⁹³ In Perth, ASIC reports that 27 trading halts were requested in February, 23 in March and 11 in April. In Brisbane, 5, 15 and 1 were requested respectively: ASIC Media Release, above n 89.

⁹⁴ ASIC Media Release MR 00/379, 'High tech disclosure not what it should be' 4/9/2000.

⁹⁵ ASIC Media Release, above n 89.

4 THE STUDY: DATA AND METHODOLOGY

4.1 INTRODUCTION

This study examines every company announcement released in response to an ASX Share Price Query between 1 January 1999 and 31 December 2000. We investigate the conduct and characteristics of listed companies that had been queried by ASX with respect to their disclosure practices, in order to further understand current compliance with the Australian continuous disclosure regime, and to provide insights for future policy and regulation in this area.

The database used in this Research Report was compiled from an ASX DataSNAP (2001) publication, which detailed company responses to all ASX queries over the 24-month period from the 1 January 1999 to 31 December 2000. This was manually sorted to identify response announcements that related to an ASX Share Price Query (hereafter Query), by cross verification with the actual announcement as published on the company announcements platform on DFS IRESS (DFS).⁹⁶ A final sample of 911 Queries was established.

For each announcement, DFS was used to collect the company name, the ASX code, the date of the actual Query and the date of publication of the company's response. Any changes in ASX code or company name over the life of the sample were also investigated, and listed in a separate field. Collection of all ASX codes allowed for the compilation of time series price data from DFS, which, in turn, enabled calculations of market-based statistics.

4.2 COMPANY BEHAVIOUR

Central to our investigation of compliance with the Australian continuous disclosure regime is an examination of the response offered by each company to the individual Queries, and their subsequent disclosure activity. Each response to a Query was then sorted according to the information contained in the response, and, in particular, the nature of the answer tendered to each question posed by ASX.

4.2.1 *Response to Query*

A typical Query issued pursuant to Listing Rule 3.1 is illustrated in Figure 4.1. Under ASX practice, a Query is issued to a listed company immediately following an unusual movement in the price of a company's securities, especially in the absence of a recent announcement that would explain the variation. Although the standard Query relates to a one-day price movement, Queries are also often associated with a concurrent increase in trading volume,

and may relate to a longer period. The routine questions in Figure 4.1 may be supplemented by specific inquiries, such as those directed towards potential abnormal profits or losses, or seeking clarification of a recent press article, or announcement by the company.

⁹⁶ DFS IRESS is a live source of ASX price data and the company announcement platform.

FIGURE 4.1: STANDARD QUESTIONS ASKED IN AN ASX QUERY RE SHARE PRICE

1. Are there any matters of importance concerning the Company about to be announced to security holders and/ or the market? If so, can an announcement be made immediately?
 2. Is the company aware of any information concerning it which, had it been available to the market, might reasonably be regarded as an explanation for recent trading in the securities of the Company?
 3. Is the Company able to offer any other explanation for the price change in the securities of the Company?
 4. Can the Company confirm to the ASX that it is in compliance with the listing rules and, in particular, listing rule 3.1?
-

Company responses in our sample varied dramatically, from a simple yes/no to each question, to a verbose monograph that failed to directly address any or all of the individual queries. Given this disparity, the answers were grouped into three broad categories.

Firstly, companies that included an announcement of new information in their response were allocated to Group 1. This would require a direct or indirect affirmation of the first question in Figure 4.1. Secondly, companies that offered no explanation of any form were allocated to Group 2. This generally arose where the company responded with a simple 'no' to the first three questions, and 'yes' to affirm that they were in compliance with the Listing Rules, with no elaboration.

The last scenario, Group 3, arose where a company denied knowledge of specific circumstances under the first two questions, but then offered one or more generalised possible explanations that did not relate to an announcement. This was offered either in reply to question 3, or in a broad statement in their response. Where the company fell into this final group, the nature of their explanation(s) was then classified. These classifications are set out in Figure 4.2.

FIGURE 4.2: CLASSIFICATION OF THE NATURE OF EXPLANATION FOR PRICE MOVEMENTS

| Category | Description |
|---|---|
| Broker Research | This category was used when a company pointed to a recently published broker report that recommended a trade in the direction of the price fluctuation. |
| Recent change in substantial shareholding | Several companies indicated that a major shareholder had recently finished a trading a large number of shares, which had eased buy or sell pressure on the securities. |
| Commodity prices | Some companies with commodity bases attributed price movements to a similar change in the respective commodity market. |
| Considering new investment opportunities | Numerous companies made a non-committal statement indicating that they were pursuing certain 'new' investments. This category is particularly relevant to junior exploration companies seeking opportunities in e-commerce or technology. |
| Industry activity | General public interest in, or speculation on, a particular industry was sometimes ascribed as the cause for a movement in a stock within that sector. |
| Market reassessment | A number of companies suggested that the movement was in line with a market recognition of growth or value (or lack thereof), or a revaluation in the light of recent announcements and events. |
| Media attention | This classification covers instances where a company drew attention to a particular media article or general press consideration of the company, its prospects and or its activities. |
| Negotiations | This category was used to cover statements to the effect that the company was in negotiations that were sufficiently uncertain as to warrant non-disclosure. |
| Speculation on next announcement | Where an announcement was known to the market to be imminent, for example where an announcement that a report on operations would soon be forthcoming had already been made, companies suggested that the fluctuation could be market conjecture as to the outcome of the announcement. |
| Recent announcements | Many companies drew the attention of ASX to one or more recent announcements in particular, or simply to 'recent announcements' in general. |
| Roadshows | Some companies indicated that variation may be due to demand arising from recent roadshows of the company's securities. |

4.2.2 Subsequent Announcements

To highlight potentially poor disclosure practices, the response to the Query was then read in conjunction with any subsequent announcement(s) made by the company during the following month. As many different announcements are required under various provisions of both the Listing Rules and the Corporations Act, an attempt was made to separate announcements of substance from those that merely reflected statutory formalities. For example, the announcement of notice of an annual general meeting (AGM) was considered to release less ‘news’ to the market than a notice of an extraordinary general meeting (EGM), that might relate to ratification of capital raisings or acquisitions, or other significant events.

Subsequent announcements were thus sorted by both their proximity to the initial Query and their nature. Broadly, the announcements were grouped into those made within one day of the announcement, within two to five days, and within one, two and four weeks. The categories by which the nature of the announcement was classified are displayed and explained in Figure 4.3.

FIGURE 4.3: CLASSIFICATION OF THE NATURE OF SUBSEQUENT ANNOUNCEMENTS

| Category | Description |
|-----------------------------|--|
| Appointment of Adviser | Where an adviser, such as financial, legal or auditor was appointed. |
| Acquisition or Agreement | This is a broad category capturing significant news events such as acquisitions, new agreements and strategic alliances. |
| Appointment of Officer | This applies where a director, company secretary or chairman was appointed. |
| ASX Query (Other) | Any query issued by the ASX besides a price query. The company's response to this new query will be a subsequent announcement to the market. For example, a query may be issued regarding Top 20 Shareholders. |
| ASX Share Price Query | A subsequent Query re share price. The company's response to this new query will be a subsequent announcement to the market. |
| Capital raising | Any form of capital raising such as a placement, rights issue etc. |
| Completion | Completion of any previously announced significant event, such as an acquisition. |
| Directors' Interests | Any change in directors' interests, including as demonstrated by statutory lodgement of changes, or by a new issue of executive options. |
| EGM | Announcement of or results from an extraordinary general meeting. |
| Trading Halt | Announcement at the request of the company of a halt in trading of the company's securities. |
| Change of Name | A change in name or business of the company |
| News or Update | Any news on a previously announced event, transaction or operation. For example, an update on operations. |
| Conversion of Notes | Conversion of convertible notes. |
| Exercise of Options | Exercise of previously issued options. |
| OS Listing or Investigation | Any investigation into the potential for, or an actual listing on an overseas exchange. |
| Other | Residual category for non-material announcements. |
| Receivership | Where a company is placed in the hands of receivers and managers. |
| Resignation of Officer | This applies where a director, company secretary or chairman resigned. |
| Change in Substantial SH | Change in the holding of a substantial shareholding as evidenced by statutory notice. |
| Statutory Announcement | Periodic financial and other reports. |
| Suspension | Suspension from trading by ASX. |
| Year 2000 | Lodgment of year 2000 compliance notice. |

4.3 COMPANY CHARACTERISTICS

In order to identify whether companies subject to a Query belong to a class with a high risk of non-disclosure, several characteristics of each company were examined. Details on age, size, industry, profitability, cash flow and dividends were collected from DFS and Huntleys' DatAnalysis,⁹⁷ which provide full text announcements and annual reports.

4.3.1 Industry

Firstly, information regarding the industry group to which each stock belongs, along with the sub-industry, was collected. This characteristic is particularly relevant as ASX and ASIC have identified high technology and mining companies as prone to non-disclosure incentives.⁹⁸ Further to this, during the period examined junior exploration companies were popular targets for 'back-door' listing of technology start-ups, a particularly high risk group. This may be attributed to the recent slump in commodity prices and the strong market demand, during this time, for tech-related stocks.⁹⁹

4.3.2 Profitability and Cash Flow

The earnings performance of a firm has long been discussed in the context of disclosure incentives. Miller¹⁰⁰ undertook an empirical investigation of corporate disclosure with increasing and decreasing earnings. Consistent with the tendency for firms to engage in strategically selective disclosure observed by Schrand and Walther,¹⁰¹ Miller documented asymmetric disclosure, decreasing in 'quantity, venue and type' with falling earnings. In light of this, the most recent earnings statistic disclosed by the company was collected from DFS IRESS, and standardised by the average number of shares in the company during the fiscal year. This provided an earnings per share (EPS) statistic that could be categorised as positive or negative, and by magnitude.

Further, the direction of the price change was posited to affect the risk of non-disclosure. Consistent with Miller, companies may be prone to a greater incentive to delay the announcement of 'bad news' relative to that of 'good news'. Therefore, the direction of the price fluctuation causing the Query was also noted in the database.

⁹⁷ Huntleys' DatAnalysis Version 4.12 as at 30 June 2000 using the FERRET Text Search/ Retrieval System.

⁹⁸ ASIC, above n 10.

⁹⁹ S. O'Malley, 'Tech Boom not all bad news for resource stocks' *Australian Associated Press*, 3 March 2000; A. Papuc, 'New economy stocks leave old fuddy-duddies for dead' *The Australian*, 11 February 2000, 30.

¹⁰⁰ Gregory S. Miller, 'Earnings Performance and Discretionary Disclosure' (Working Paper, Harvard Business School, 1999).

¹⁰¹ C.M. Schrand, and B.R. Walther, 'Discretionary Reporting of Earnings Components' (Working Paper, University of Pennsylvania, 1998).

This theme was also investigated in the context of cash flows and the payment or non-payment of dividends. The financial period change in cash was obtained from the most recent financial report of every queried company. This report was also used to collect the ending cash amount, as this enabled the company's liquidity to be examined from the direction of the change in cash relative to the final balance. Dividends are widely argued to act as a proxy for information signalling with regards to a company's predicted future cash flows.¹⁰² The ex-dividend date and amount of the last dividend paid by the company (if any) was thus incorporated into the database.

4.3.3 *Age and Size*

Both the listing and, if applicable, delisting dates for each company were collected. The former provides a proxy for company age, whilst the latter eliminates the effect of survivorship bias by ensuring our study includes non-survivors. A greater company age correlates with a greater opportunity to have developed practical policies and guidelines for corporate disclosure. However, in a market environment pervaded by merger activity in its various forms, the listing date was viewed and interpreted in the context of changes of name and business.

Further, age of itself is not determinative of good practice. It is argued that company size is an additional contributing factor to the existence of internal routines and standards that promote better disclosure practice. Measuring company size in a manner meaningful to future cash flows and prospects in the current market context is, to say the least, complicated. Further, it is less of a precise science than the fabled discounted cash flow techniques of financial valuation theory would suggest. Recent market volatility and the now infamous 'tech bubble' have led to substantial valuation difficulties. For example, over our two-year sample period Davnet Limited's share price varied from a low of \$0.19 to a high of \$6.00 (a 3,058% variance) directly before the 'tech bubble' burst and devastated inflated stock prices in the technology, biotechnology and telecommunications sectors. In light of these difficulties, and with the knowledge that the fundamental focus of this Research Report is one of compliance rather than valuation, it seemed most prudent to use the closing price on the day of the response to the Query multiplied by the weighted average number of shares in that year to proxy for company size. This best reflects the size of the company at the time of the Query, which is particularly important given the huge variation in market valuations over the course of the sample period.¹⁰³

¹⁰² See, for example R.A. Brealey, 'Does Dividend Policy Matter' in J.M. Stern and D.H. Chew Jr. (eds), *The Revolution in Corporate Finance* (1992) 439-444; F. Black, 'The Dividend Puzzle' (1976) *Journal of Portfolio Management* 634-639.

¹⁰³ The average market capitalisation of companies at the time of the Query was \$500 million, whereas the average market capitalisation for the same sample of companies as at 18 April 2001 was \$300 million.

Small stocks provide an area of particular concern. Information acquisition for investors is both costly and time consuming, especially in the domain of smaller stocks. For this reason, it is especially important that these companies comply with the continuous disclosure obligations, but paradoxically, they pose a particularly high risk of non-disclosure. For investors, it is argued that returns to information acquisition decrease with an increasing number of traders,¹⁰⁴ thus where small but popular stocks, such as technology companies, are heavily traded, following the market may become the rational alternative to independent research. In this event, it is crucial that the market is informed, which requires diligent compliance by the company with the continuous disclosure regime.

¹⁰⁴ Kenneth Froot, David Scharfstein, and Jeremy Stein, 'Herd on the Street: Informational Inefficiencies in a Market with Short-Term Speculation' (1992) 47(4) *Journal of Finance* 1461.

5 RESULTS AND DISCUSSION

This Report investigated 911 Queries issued by ASX for unusual stock price movements during the 2-year window from 1 January 1999 to 31 December 2000. These Queries aim to explore and clarify the state of the receiving company's compliance with the Australian continuous disclosure regime outlined in Section 3 of this Report. Our contribution aims to supplement investigations undertaken by ASIC and ASX by analysing corporate behaviour during and subsequent to a Query, and by highlighting characteristics which may be associated with incentives for non-disclosure. The first part of this section provides an overview of the research sample, the second stage addresses corporate conduct, and the final stage examines the company characteristics.

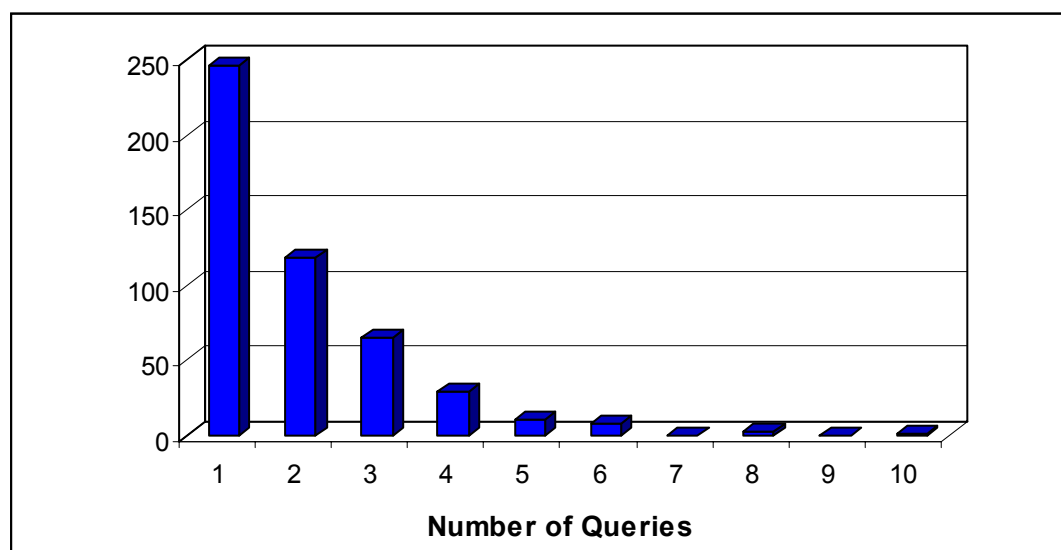
Table 5.1 presents summary statistics for our sample, which highlight that the average company subjected to continuous disclosure scrutiny during this 2-year period was likely to receive a second 'please explain' in this period. The maximum number of Queries incurred by a single company was 10.

TABLE 5.1: SUMMARY STATISTICS ON NUMBER OF QUERIES

| <i>Number of Queries</i> | <i>Average Number per Company</i> | <i>Maximum Number of Queries</i> |
|--------------------------|-----------------------------------|----------------------------------|
| 911 | 1.91 | 10 |

As demonstrated by Figure 5.1 below, 118 companies received two Queries during the interval, and over 65 received three. In total, 478 companies were asked to account to ASX for unexplained share price fluctuations. These initial results stress the importance of investigation beyond the Query. To the extent that the examined price variation could imply sub-optimal disclosure, it would appear that the Query, of itself, does not always provide sufficient incentive to improve disclosure so as to avoid a repeat Query.

FIGURE 5.1: NUMBER OF QUERIES PER COMPANY



5.1 COMPANY BEHAVIOUR

Table 5.2 summarises the responses to the 911 Queries by the categories outlined in Section 4. Group 1 represents companies that included an announcement of new information in their response. Companies that offered no explanation of any form are included in Group 2. Group 3 arose where a company denied knowledge of specific circumstances under the first two questions, but then offered one or more generalised possible explanations that did not relate to an announcement.

These results indicate that in 145 cases, the Query drove the company to release pertinent information to the market. This leaves it open to speculation when the information would have been released in the absence of a Query.

TABLE 5.2 QUERY RESPONSES

| <i>Group</i> | <i>Number</i> | <i>Proportion</i> |
|--------------|---------------|-------------------|
| 1 | 145 | 15.92% |
| 2 | 279 | 30.63% |
| 3 | 487 | 53.46% |

From Table 5.3 it is clear that many of these announcements were substantial, relating to events such as strategic agreements or acquisitions (33.8%), or operational news (55.2%). It is interesting to note that 7.6% of companies requested a trading halt as part of their response to the Query.

TABLE 5.3 NATURE OF ANNOUNCEMENT INCLUDED IN RESPONSE (GROUP 1)

| Category | Number | Proportion (%) |
|------------------------------------|---------------|-----------------------|
| Acquisition/ divestment/ agreement | 49 | 33.79% |
| Appointment of Officer | 8 | 5.52% |
| Capital raising | 18 | 12.41% |
| Change in substantial shareholding | 2 | 1.38% |
| News on operations | 80 | 55.17% |
| OS listing or investigation | 1 | 0.69% |
| Resignation | 1 | 0.69% |
| Trading halt | 11 | 7.59% |

**Proportions do not sum to 1 as some companies made an announcement relating to more than one event*

The 279 companies in Group 2 offered no form of explanation for the movement in their share price. Group 3, however, representing 53.5% of the sample, offered some ‘other’ information that might explain the variation, the details of which are described in Table 5.4.

TABLE 5.4: GROUP 3 BY EXPLANATION

| Category | Proportion of Companies (%) |
|---|------------------------------------|
| Broker Research | 6.76% |
| Recent change in substantial shareholding | 2.66% |
| Commodity prices | 2.05% |
| Industry activity | 8.20% |
| Market reassessment | 13.52% |
| Media attention | 12.91% |
| Negotiations | 18.44% |
| Considering new investment opportunities | 11.68% |
| Recent announcements | 59.22% |
| Roadshows | 2.46% |
| Speculation on next announcement | 11.07% |

**Proportions do not sum to 1 as some companies offered more than one explanation*

The majority of companies offering auxiliary information (59%) drew the attention of ASX to recent announcements made by the company. They argued, in general, that the market was simply demonstrating a delayed reaction to information previously disclosed. Further to this theme, 13.5% of respondents theorised that traders were reassessing information or events in the market, such as growth potential attributable to a recently appointed management team. An additional 11.1% claimed that the market was merely speculating on the outcome of an

imminent announcement, such as results of recent drilling operations. Also common was a non-committal indication that the company was pursuing new investment opportunities (11.7%) or negotiations (18.4%).

These results suggest that companies may be reluctant to admit non-disclosure, while still needing to release some information to the market as a consequence of the ASX Query. This view is supported by the large number of companies that release market sensitive information in the period immediately following their response to the query.

Table 5.5 sets out the subsequent announcements grouped according to how long after the Query they were released to the market. The intention of this investigation was to capture the number of days between the Query and the next material announcement, subject to a 30-day limit. Consequently, up to 4 announcements were collected for each query, as often the initial subsequent announcements did not contain information likely to have a material effect on the share price or value. In considering subsequent announcements, any announcements made in conjunction with the response to the Query were not included. These were considered to form a part of the response to the Query, and, where such a response was made, the company was included in Group 1, and the announcement was dealt with separately. Table 5.3 sets out the results and statistics of announcements made in this fashion.

It is interesting to note that in the first day following the Query, the four most common announcements were news or update on operations (20.3%), the release of statutory announcement, such as half-year, full-year or quarterly cashflow statements (18.5%), the announcement of an acquisition or agreement (14.1%) and the announcement of a capital raising (9.0%). This suggests that companies may not be adequately answering the ASX questions, particularly Question 2 which requires the company to release any information they are aware of that, if released, *might* affect the share price.¹⁰⁵

In a 2 to 5 day period following the Query, the most common announcement was a statutory announcement (19.9%), followed by news or update on operations (18.0%), change in substantial shareholding (12.6%), announcement of an acquisition or agreement (10.2%) and change in director's interests (9.2%).

While there is still obviously substantial news on operations being released to the market, it is interesting to note that over 20% of announcements relate to trading by substantial shareholders and insiders (directors).

Under s671B, changes in substantial shareholdings must be disclosed within 2 business days. This means that, for substantial shareholding notices provided in the 2 to 5 day period

¹⁰⁵ Our emphasis.

following the Query, the trading announced in the substantial shareholding notice occurred after the Query.¹⁰⁶

Directors, however, under s205G have 14 days to disclose any change in interests. Accordingly, where directors lodge change in interest notices within 2 to 5 days of a Query, it is likely that the directors were trading in the period leading up to the Query. This in turn raises the question of whether they were trading on information not yet released to the market.¹⁰⁷

In the 6 to 15 day period, the most common announcement was again a statutory announcement (23.9%), followed by news or an update on operations (21.1%), an announcement of an acquisition or agreement (11.4%), change in substantial holding (9.7%) and change in director's interests (8.1%).

For the 16 to 30 days following the Query, the most common subsequent announcement was a statutory announcement (25.0%), followed by news or update on operations (19.4%) and changes in director's interests (9.3%). The number of announcements in the later part of the month following the Query is less likely to represent evidence of nondisclosure, given the increased time lag between issuance of the Query and the announcement.

¹⁰⁶ This assumes the substantial shareholding notice was lodged within the 2 business days required by the Corporations Act.

¹⁰⁷ ASX has proposed reducing the time period from 14 days to 5 days in order to improve the provide information in a timely fashion. 14 days is seen as 'too late for investors to make a decision as to whether a director who bought or sold shares in their company signalled full confidence in the company or the reverse': Annabel Hepworth, 'ASX to tighten rules for directors', *The Australian Financial Review*, 15 May 2001, 3.

TABLE 5.5: SUBSEQUENT ANNOUNCEMENTS

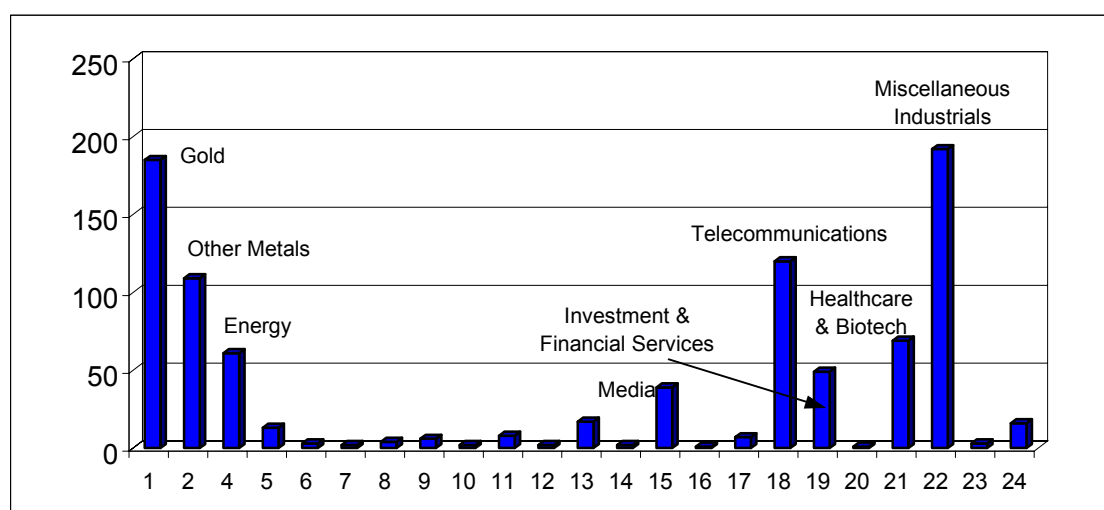
| Category | 0 to 1 days | | 2 to 5 days | | 6 to 15 days | | 16 to 30 days | |
|-----------------------------|-------------|-------------|-------------|-------------|--------------|-------------|---------------|-------------|
| | Number | % | Number | % | Number | % | Number | % |
| Acquisition or Agreement | 55 | 14.10% | 42 | 10.19% | 80 | 11.38% | 54 | 8.65% |
| Appointment of Adviser | 1 | 0.26% | 1 | 0.24% | 1 | 0.14% | 3 | 0.48% |
| Appointment of director | 6 | 1.54% | 14 | 3.40% | 23 | 3.27% | 15 | 2.40% |
| ASX Query (Other) | 5 | 1.28% | 15 | 3.64% | 11 | 1.56% | 9 | 1.44% |
| ASX Share Price Query | 7 | 1.79% | 7 | 1.70% | 17 | 2.42% | 14 | 2.24% |
| Capital raising | 35 | 8.97% | 34 | 8.25% | 51 | 7.25% | 50 | 8.01% |
| Completion | 9 | 2.31% | 5 | 1.21% | 5 | 0.71% | 6 | 0.96% |
| Directors' Interests | 24 | 6.15% | 38 | 9.22% | 57 | 8.11% | 58 | 9.29% |
| EGM | 6 | 1.54% | 3 | 0.73% | 4 | 0.57% | 3 | 0.48% |
| Trading Halt | 22 | 5.64% | 7 | 1.70% | 8 | 1.14% | 10 | 1.60% |
| Change of Name | 2 | 0.51% | 2 | 0.49% | 3 | 0.43% | 2 | 0.32% |
| News or Update | 79 | 20.26% | 74 | 17.96% | 148 | 21.05% | 121 | 19.39% |
| Conversion of Notes | 1 | 0.26% | 1 | 0.24% | 3 | 0.43% | 2 | 0.32% |
| Exercise of Options | 10 | 2.56% | 12 | 2.91% | 17 | 2.42% | 22 | 3.53% |
| OS Listing or Investigation | 2 | 0.51% | 2 | 0.49% | 2 | 0.28% | 5 | 0.80% |
| Other | 0 | 0.00% | 2 | 0.49% | 2 | 0.28% | 2 | 0.32% |
| Receivership | 0 | 0.00% | 1 | 0.24% | 1 | 0.14% | 1 | 0.16% |
| Resignation of Director | 11 | 2.82% | 10 | 2.43% | 17 | 2.42% | 19 | 3.04% |
| Change in Substantial SH | 35 | 8.97% | 52 | 12.62% | 68 | 9.67% | 50 | 8.01% |
| Statutory Announcement | 72 | 18.46% | 82 | 19.90% | 168 | 23.90% | 156 | 25.00% |
| Suspension | 1 | 0.26% | 2 | 0.49% | 4 | 0.57% | 3 | 0.48% |
| Year 2000 | 7 | 1.79% | 6 | 1.46% | 13 | 1.85% | 19 | 3.04% |
| TOTAL | 390 | 100% | 412 | 100% | 703 | 100% | 624 | 100% |

5.2 CHARACTERISTICS

5.2.1 Industry

To further investigate the composition of our sample, the Queries were categorised by ASX sector. As discussed in Section 4, some sectors of the market could be more prone to incentives for non-disclosure. Figure 5.2¹⁰⁸ examines a breakdown of the number of Queries issued by industry. It becomes clear that the mining sector, represented by Gold and Other Metals, and the Miscellaneous Industrials sector have a higher incidence of Queries than other sectors.

FIGURE 5.2: NUMBER OF QUERIES BY INDUSTRY



Further investigation reveals, these industries have more in common than their titles would suggest. Seventy-eight of the 478 companies in the sample changed their name and their business over the course of the sample.¹⁰⁹ Miscellaneous Industrials, Telecommunications, Healthcare and Biotechnology and Investment and Financial Services companies were particularly prone to name and business change. This is not unexpected given that these sectors were particularly prone to ‘backdoor listings.’ These companies were often originally resources/gold companies seeking greater growth in a time of depressed level of commodity prices, lack of investor interest in the resources sector and the general interest in the ‘new economy’ story.

¹⁰⁸ Refer to Appendix 1 for details of the numbered categories used in this Figure. Note also Appendix 2, which shows the average number of queries per company by sector.

¹⁰⁹ For a breakdown of name changes by sector, see Table 5.8.

TABLE 5.7: NUMBER OF QUERIES BY INDUSTRY

| Sector | Sub Sector | | | | | | | | Total |
|---------------------------------|------------|-----|----|----|----|----|----|----|-------|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | |
| Gold | 11 | 171 | 1 | | | 2 | | | 185 |
| Other Metals | | 18 | 5 | | 15 | 17 | 51 | 3 | 109 |
| Energy | 8 | 40 | | | 11 | 2 | | | 61 |
| Infrastructure & Utilities | | 10 | 2 | 1 | | | | | 13 |
| Developers & Contractors | | 1 | | | 2 | | | | 3 |
| Building Materials | 1 | | | 1 | | | | | 2 |
| Alcohol & Tobacco | 2 | 2 | | | | | | | 4 |
| Food & Household | 4 | | | 2 | | | | | 6 |
| Chemicals | | 2 | | | | | | | 2 |
| Engineering | | | | 1 | 7 | | | | 8 |
| Paper & Packaging | | | | 2 | | | | | 2 |
| Retail | 15 | 1 | | 1 | | | | | 17 |
| Transport | | | 2 | | | | | | 2 |
| Media | 24 | 1 | 7 | | 7 | | | | 39 |
| Banks & Finance | 1 | | | | | | | | 1 |
| Insurance | 6 | 1 | | | | | | | 7 |
| Telecommunications | 9 | 1 | 56 | 54 | | | | | 120 |
| Investment & Financial Services | 7 | 22 | 1 | | 19 | | | | 49 |
| Property Trusts | 1 | | | | | | | | 1 |
| Healthcare & Biotechnology | 10 | 30 | 4 | 10 | 15 | | | | 69 |
| Miscellaneous Industrials | 22 | 16 | 9 | | 4 | 83 | 9 | 49 | 192 |
| Diversified Industrials | 3 | | | | | | | | 3 |
| Tourism & Leisure | 14 | | 2 | | | | | | 16 |

171 of the 185 Queries to the Gold sector were issued to exploration companies, which arguably carry a very high level of operational risk and are also prime targets for transformation to ‘new economy’ stocks. While Gold companies made up only 6.96% of the companies who changed their name (see Table 5.8), many were quite overt in seeking technology opportunities at the height of the tech boom, and often changed their status from No Liability to Limited companies in order to enable them to pursue technology opportunities.¹¹⁰

Miscellaneous Industrials comprises, amongst others sub-groups, Computer & Office Related Supplies and High Technology. These sectors received 83 and 49 Queries respectively, which, alongside the notable numbers issued to the Telecommunications and Healthcare & Biotechnology sectors, reinforces the concern that ‘new economy’ stocks raise fresh issues in policing the continuous disclosure regime.

The breakdown of queries by sector and sub-group is outlined in Table 5.7.¹¹¹

TABLE 5.8: QUERIES ON COMPANIES WITH NAME CHANGES DURING SAMPLE

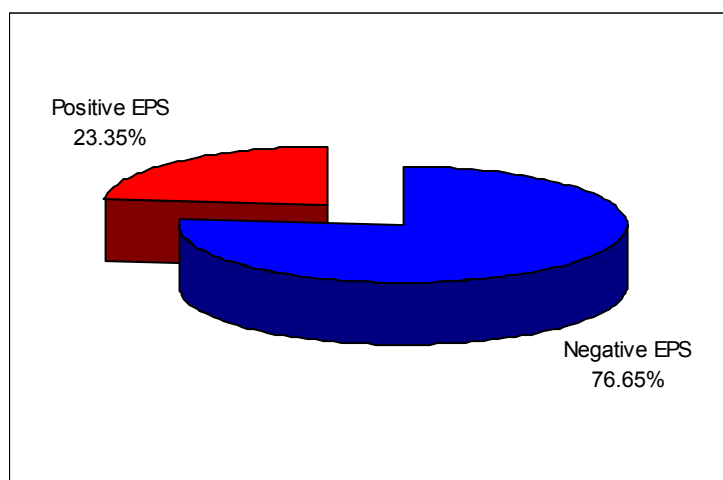
| Sector | Percentage of Company Name Changes by Sector |
|---------------------------------|---|
| Gold | 6.96% |
| Other Metals | 5.70% |
| Energy | 2.53% |
| Retail | 2.53% |
| Media | 4.43% |
| Telecommunications | 27.85% |
| Investment & Financial Services | 10.76% |
| Healthcare & Biotechnology | 10.76% |
| Miscellaneous Industrials | 26.58% |
| Tourism & Leisure | 1.90% |
| TOTAL NAME CHANGES | 100.00% |

¹¹⁰ No Liability companies are unique in that under s254M(2) of the Corporations Act a shareholder is not obliged to pay calls in respect of the share or any contribution to the debts and liabilities of the company. However, under s112(2) a no liability company must have mining purposes as its sole objects in its constitution, and under s 112(3), such a company must not engage in activities outside these objects.

¹¹¹ Refer to Appendix 1 for details of the numbered categories used in this Table.

5.2.2 Profitability and Cash Flow

FIGURE 5.3: PROFITABILITY



Consistent with the discussion in Section 4, Figure 5.3 shows that the vast majority of Queries related to companies with negative standardised earnings. This confirms the view that a lack of current profitability increases the risk of unexplained price movements and consequently the likelihood of non-disclosure by companies. Further, Table 5.9 demonstrates that those industries with lower earnings are more likely to be subject to Queries.

Cash flow difficulties could also have a relationship with non-disclosure. Regardless how profitable a company is, if its liquid assets are insufficient to cover day to day requirements, financial distress is more likely. Figures 5.4 and 5.5 depict cash flow by change in cash from the previous financial period, and cash levels at the end of the period.

Of the four possible outcomes, a decrease in cash combined with a negative ending cash balance has the greatest potential for concern, particularly with regard to insolvent trading. Although this is not a common outcome within this sample, it is interesting to note that of the 52 Queries that related to a company with these cash flow characteristics, over 80.8% of these related to companies within the 'new economy' sectors earlier identified.¹¹²

¹¹² 53.8% in Miscellaneous Industrials, 19.2% in Telecommunications and 7.7% in Healthcare & Biotechnology.

TABLE 5.9: AVERAGE EPS BY SECTOR

| | Sector | Average EPS |
|----|---------------------------------|--------------|
| 1 | Gold | -0.73 |
| 2 | Other Metals | -5.25 |
| 4 | Energy | -8.49 |
| 5 | Infrastructure & Utilities | 11.06 |
| 6 | Developers & Contractors | 40.15 |
| 7 | Building Materials | 9.45 |
| 8 | Alcohol & Tobacco | 2.98 |
| 9 | Food & Household | 3.66 |
| 10 | Chemicals | -8.25 |
| 11 | Engineering | -8.51 |
| 12 | Paper & Packaging | 26.35 |
| 13 | Retail | 8.32 |
| 14 | Transport | 162.00 |
| 15 | Media | -2.19 |
| 16 | Banks & Finance | 19.90 |
| 17 | Insurance | -21.24 |
| 18 | Telecommunications | -6.94 |
| 19 | Investment & Financial Services | -0.23 |
| 20 | Property Trusts | 7.90 |
| 21 | Healthcare & Biotechnology | -6.53 |
| 22 | Miscellaneous Industrials | -3.51 |
| 23 | Diversified Industrials | 12.30 |
| 24 | Tourism & Leisure | -7.14 |
| | Overall | -2.99 |

FIGURE 5.4: CHANGE IN CASH FLOW

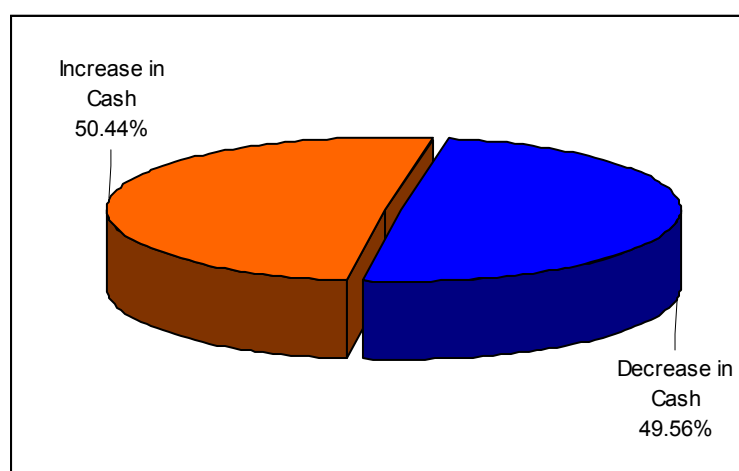
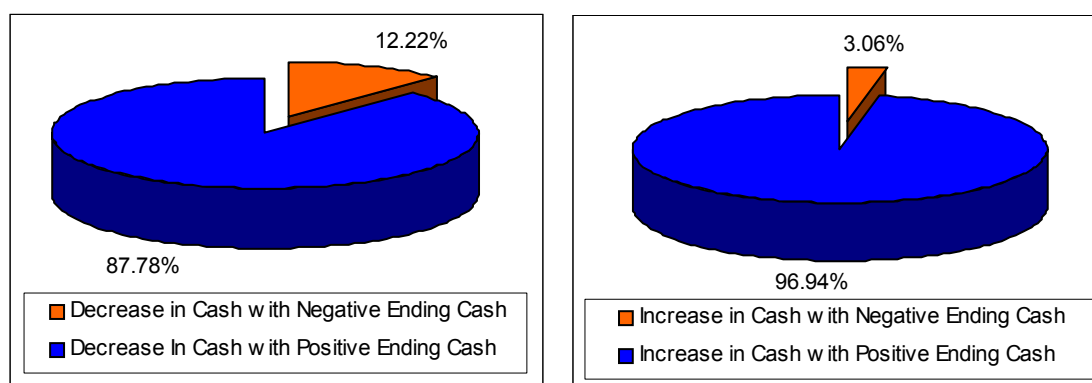


FIGURE 5.5: CHANGE IN CASH FLOW AND ENDING CASH



5.2.3 Direction of Price Change

As seen in Table 5.10 below, the bulk of the Queries relate to price increases rather than decreases. This may seem counter-intuitive given that the vast majority of companies in our sample (77%) have negative current earnings. However, the market price of a security is argued to reflect the market's expectation not only of current earnings, but also of all future earnings. For many of the companies in our sample, although current earnings are negative, the market may, through an increasing share price, be indicating expectations of substantial *future* earnings.

However, contrary to financial theory, it is possible that the price increase could reflect a rumour, misinformation or uninformed trading distorting the share price. It could reflect informed traders trading off these uninformed traders to their benefit. The nature of trading and the identity of traders during this period of misinformation would be open to speculation.

This should not, however, detract from the gravity of, and thus the emphasis on, non-disclosure in the context of declines in corporate value and/or potential liquidity crises. The substantial risks faced by shareholders as the residual claimants on firm property crystallise in an environment of financial distress.

TABLE 5.10: PROPORTION OF QUERIES BY DIRECTION OF PRICE CHANGE

| <i>Queries on Increased Prices</i> | <i>Queries on Decreased Prices</i> |
|------------------------------------|------------------------------------|
| 93.86% | 6.14% |

It is interesting to note from Table 5.11 that the highest average price change that is the subject of a price query is in the Building Materials sector, followed by Media, Gold and Engineering. This may suggest that some ‘old-economy’ sectors may not be subject to same level of scrutiny as others such as Transport, where a price change of 2.69% was sufficient to warrant a query. This result may be a reflection of the relative volatility of trading in these sectors.

Within the ‘new economy’ sectors, the average price change for the Miscellaneous Industrials sector was 10% greater than that for Telecommunications and Healthcare & Biotechnology, suggesting greater scrutiny. However, it should be noted that all 3 of these sectors are in the mid-range of average price changes subject to queries.

TABLE 5.11: AVERAGE CHANGE IN PRICE PER SECTOR

| | Sector | Average Price Change that is the subject of the Query |
|----|---------------------------------|--|
| 1 | Gold | 57.92% |
| 2 | Other Metals | 43.98% |
| 4 | Energy | 54.08% |
| 5 | Infrastructure & Utilities | 17.65% |
| 6 | Developers & Contractors | 41.96% |
| 7 | Building Materials | 93.81% |
| 8 | Alcohol & Tobacco | 27.72% |
| 9 | Food & Household | 20.20% |
| 10 | Chemicals | 36.05% |
| 11 | Engineering | 55.60% |
| 12 | Paper & Packaging | 7.74% |
| 13 | Retail | 32.38% |
| 14 | Transport | 2.69% |
| 15 | Media | 60.06% |
| 16 | Banks & Finance | 2.78% |
| 17 | Insurance | 6.54% |
| 18 | Telecommunications | 42.26% |
| 19 | Investment & Financial Services | 54.71% |
| 20 | Property Trusts | 17.65% |
| 21 | Healthcare & Biotechnology | 41.50% |
| 22 | Miscellaneous Industrials | 50.36% |
| 23 | Diversified Industrials | 7.39% |
| 24 | Tourism & Leisure | 47.16% |
| | Overall | 48.45% |

5.2.4 Size

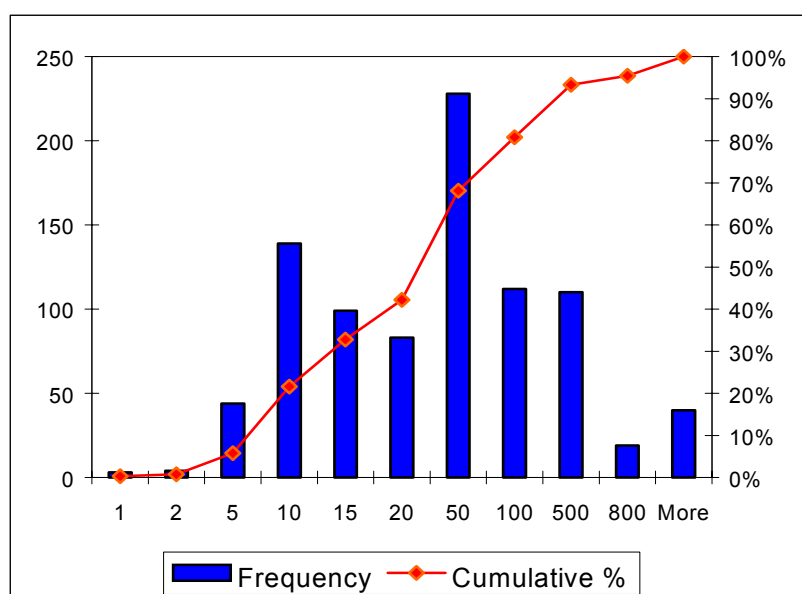
Our sample of Queries was overwhelmingly comprised of small capitalisation stocks, indicating, consistent with our prediction, that smaller companies may have a greater propensity for non-disclosure. Table 5.12 illustrates that under several measures of small capitalisation, such stocks account for over 80% of the Queries. Indeed, where the measure applied is \$800 million, a widely used industry cut-off, this proportion extends to over 95%. This suggests that effective continuous disclosure enforcement activity should be particularly targeted towards smaller companies, where effective implementation of continuous disclosure programs would seem to be less successful than in large publicly listed companies.

TABLE 5.12: PROPORTION OF COMPANIES BY SIZE

| <i>Market Capitalisation</i> | <i>Proportion of Companies</i> |
|------------------------------|--------------------------------|
| Less than \$100 million | 80.80% |
| Less than \$250 million | 88.98% |
| Less than \$500 million | 93.30% |
| Less than \$800 million | 95.45% |

Figure 5.6 below extends this demonstration to show cumulative percentages of companies with size on a non-linear scale. A non-linear scale was necessary due to the extreme clustering below the \$100 million mark. Over 80% of price queries were sent to companies with a market capitalisation at the time of the response of less than \$100 million.

FIGURE 5.6: CUMULATIVE HISTOGRAM- PROPORTION OF COMPANIES BY SIZE



6 CONCLUSION AND IMPLICATIONS

This Report addresses a substantial gap in the current disclosure literature. We have examined the conduct and characteristics of listed companies that have been queried by ASX with respect to their disclosure practices. Consistent with research discussing corporate incentives for non-disclosure, we highlight a potential lack in candour in disclosure activity. This is demonstrated through the large number of Queries issued during our sample period, the distinct similarities displayed by scrutinised companies, and the time and nature of announcements made by companies subsequent to the Queries. These results suggest several policy implications, which will be discussed below.

6.1 SUMMARY OF RESULTS

A total sample of 911 Queries issued by ASX for unusual stock price movements during the 2-year window from 1 January 1999 to 31 December 2000 was examined. On average, each company in the sample received two queries, suggesting that multiple Queries were common. Indeed, one company received ten Queries in the sample period.

Companies receiving Queries were predominantly from Miscellaneous Industrials, Gold and Telecommunications sectors, followed by Other Metals and Healthcare & Biotechnology. Most companies in the sample had negative current earnings (76.65%), but most Queries related to increases in share price (93.86%), arguably reflecting market expectations in relation to future earnings of queried companies. The companies in the sample were overwhelmingly small capitalisation stocks.

In 145 of the 911 observations, the Query drove the company to release pertinent information to the market in conjunction with their Query response, with 55.17% of these cases releasing news on their operations, and 33.79% including information relating to an acquisition, divestment or agreement. In 487 observations, the company did not make a major announcement with their response, but included some attempt at explaining the share price movement, mainly in relation to other recent announcements made by the company (59.22%).

Companies in the sample were prone to making subsequent announcements in close proximity to the Query. Of the announcements made in the first day following the Query, 20.3% of these related to news on the company's operations and 14.1% related to an acquisition, divestment or agreement. A total of 390 announcements were made on the day following a Query. Updating the market on operations or releasing information relating to an acquisition, divestment or agreement were also common announcements in the two to five day period following the Query (18.0% and 10.2% respectively), when another 412 announcements were made.

6.2 PROFILE OF A HIGH-RISK COMPANY

This Research Report highlights characteristics that may help regulators identify companies with a particular propensity towards non-disclosure. Profitability and size appear to be key identifiers of companies that may have a greater potential for nondisclosure, evidenced by a higher likelihood of having unexplained movements in their security prices. This risk increases where the company belongs to, or is influenced by, the ‘new economy’ such as the Technology, Biotechnology, Telecommunications and Exploration sectors.

Given the popularity of these stocks amongst an increasing retail and ‘uninformed’ trading clientele, special attention to the disclosure compliance of companies fitting this profile may be warranted to preserve market integrity, and to ensure adequate investor protection.

The results of this Research Report reinforce and provide evidence for the perception held by regulators that compliance by new technology companies with the continuous disclosure regime is an area of current concern.¹¹³ Additional steps are needed in targeting, surveillance and education. The problem areas identified in this study could aid future policy directions in these areas. This profile may be used, for example, to increase the effectiveness and efficiency of enforcement through monitoring of higher-risk companies in relation to their disclosure activities. It could also be used to target further education and guidance towards key risk groups. At the outset, the work commenced by ASX and ASIC in 2000 needs to be continued, and potentially expanded. In spite of the current continuous disclosure program initiated by the regulators, this Report demonstrates that unexplained price movements are still prevalent. Increased investigation of responses to Queries is likely to lead to greater disclosure by companies as a whole, and not just those companies subjected to a Query.

6.3 RESPONSE TO ASX QUERY

Standard Question 1

‘Are there any matters of importance concerning the Company about to be announced to security holders and/ or the market? If so, can an announcement be made immediately?’

Standard Question 2

‘Is the company aware of any information concerning it which, had it been available to the market, might reasonably be regarded as an explanation for recent trading in the securities of the Company?’

Many companies appear to treat questions 1 and 2 posed by ASX as indistinct. If an announcement is not immediately required under Listing Rule 3.1, they seem to interpret this

as meaning they can also deny ‘awareness’ of the *same* information in responding to question two. This is intuitively inconsistent with the intentions of ASX in issuing two separate questions.

Although 279 companies in the sample provided no explanation at all for the share price movement, 802 announcements¹¹⁴ were made in the first five days following Queries issued to the companies in the sample.

Responses to this query seem to be contrary to both the wording of the question, and its spirit. The ability to use the exception in Listing Rules 3.1.1 to 3.1.3 to avoid disclosure at the relevant time is arguably distinct from ‘awareness’ of material information at that same time. In answering the Query, it would appear more appropriate for the company to acknowledge the existence of circumstances, that, were they known, could explain the price movement under question 2, but indicate that disclosure was not required at this point under question 1. For example, if a company is aware of a potentially material piece of information which could indeed, were it disclosed, explain the trading, it seems more appropriate to state ‘We have nothing to disclose under the Listing Rules at this point’ rather than ‘We *know* nothing.’

6.4 TIMELINESS OF COMPLIANCE

Many companies appear to behave in a reactive rather than proactive fashion in their approach to the continuous disclosure obligations. Of the 911 Queries in our sample, 145 responses included the release of material information. This is arguably in breach of Listing Rule 3.1, and inconsistent with the continuous disclosure requirements that place the onus on companies to offer information in a timely fashion. Indeed, the criterion in the Listing Rules is ‘immediately’, which implies action with due haste and without waiting, whereas current conduct of some companies seems closer to a ‘last second’ mentality. Further, reactive behaviour is inconsistent with the principles laid down in Listing Rule 19.2, which indicate that an entity is obliged to comply with the Listing Rules in line with their ‘spirit, intention and purpose’, rather than a technical reading of their meaning.

6.5 UNDERSTANDING THE EXCEPTIONS TO LISTING RULE 3.1

One further implication arising from the examination of the responses to the Queries is that some companies appear to regard Listing Rules 3.1.1, 3.1.2 and 3.1.3 as three discrete exceptions rather than components of one exception. This is indicated, for example, by responses indicating information cannot be disclosed due to a confidentiality agreement. In

¹¹³ See, eg, ASIC, above n 11 and n 89.

¹¹⁴ Note that each company may have made more than one ‘announcement’ in a singular media release. Where more than one announcement was contained in one release, each announcement has been included and counted separately.

and of itself, confidentiality is not sufficient to meet the exception requirements in the Listing Rules. The company would need to establish, *inter alia*, that a reasonable person would not expect disclosure. To the extent that a rampant rumour is distorting the share price, this exception might not be valid. In such a scenario, clarification of some form would be required regardless of the confidentiality. If such clarification is not possible, a trading halt should be requested.

6.6 FURTHER DIRECTIONS IN SURVEILLANCE AND EDUCATION

The results of this Research Report highlight and reinforce the notion already entertained by regulators that continuous disclosure compliance is an area of current concern. The conclusion has outlined several weaknesses that have been brought to light through this study. We have examined the characteristics of companies that have been subject to ASX Queries with regard to their disclosure practices, and also examined what appear to be systematic shortcomings in compliance with the current continuous disclosure regime. Our findings suggest that there may be inherent incentives for non-disclosure. Non-disclosure is a very real threat to the efficiency and integrity of Australian markets.

In addition to the profiling suggested in Section 6.2, some consideration may be given to the current formulation of the typical Query questions posed by ASX in light of the adequacy of the answers offered. Respondents may need to be given further guidelines with regard to the information that needs to be disclosed pursuant to each question.¹¹⁵ This may be achieved, for example, through the development of a new set of clarified questions. Further, additional guidelines explaining these questions and/or further guidance amplifying the nature of the obligations that arise generally under Listing Rule 3.1 and more specifically under a Query could also assist directors and management to achieve a higher level of compliance.

We have identified further education as a key requirement for the effective operation of the continuous disclosure regime. However, the results could also indicate that the difficulties inherent in proving breaches of the disclosure regime, and consequently of imposing sanctions, are bolstering a lax approach to continuous disclosure. The risk of prosecution or other serious action can serve as a valuable deterrent, and may be an avenue that needs to be explored. As noted by David Knott, Chairman of ASIC, ‘at present it is a bit unsatisfactory that the only thing we can do is - at best - get better disclosure out, but at very little penalty to the organisation involved.’¹¹⁶ He has proposed bolstering enforcement of the disclosure regime with greater financial penalties. This is now part of the *Financial Services Reform Act*

¹¹⁵ Although ASX has recently re-released the Guidance Note on Listing Rule 3.1 (September 2001), few substantive changes have been made apart from incorporating ASIC’s guidance principles as contained in ‘Better Disclosure to Investors’ (2000), which was already available to the market.

¹¹⁶ Pheasant, Bill and Main, Andrew ‘ASIC proposes fines for non-disclosure’ *Australian Financial Review* 7 May 2001, 41.

2001,¹¹⁷ but how these new provisions will be used is yet to be seen. If one accepts that a Query may highlight a potentially poor disclosure practice, evidence that companies in the sample received up to ten Queries suggests that the issuance of a Query in its current form may not of itself be providing sufficient incentive to alter disclosure practices.

Given that the nature of the continuous disclosure regime imports a duty to monitor information, it is important for companies to establish a suitable 'information protocol' to ensure compliance and reduce liability. Recent disclosure guidance notes issued by ASIC¹¹⁸ could potentially be expanded, and directors encouraged and educated to effectively implement these procedures within their organisations. A systematic approach to the assessment of information for disclosure needs to be adopted within all listed companies, especially those which have been profiled as high-risk, and, being characteristically smaller and younger, may not currently have an adequate procedure in place.

Compliance with the Australian continuous disclosure regime is an area that warrants further consideration from directors and regulators alike. Transforming the level of compliance goes beyond the strengthening of regulatory provisions by the *Financial Services Reform Act*. The process does not end here. Continued supervision and education is not just desirable, but required. The importance of an informed market is clear, and the development of appropriate systems to deter and avoid non-compliance is vital to the defence to the future of ASX as an efficient and liquid market.

¹¹⁷ Failure to comply with the new Ch 6CA Continuous Disclosure provisions included by the Financial Services Reform Act can be both an offence and subject to civil penalties.

¹¹⁸ See, eg, ASIC Guidance Rules 'Better Disclosure for Investors' (2000), as incorporated in the new ASX Guidance Note to Listing Rule 3.1.

APPENDIX 1 – AUSTRALIAN STOCK EXCHANGE INDUSTRY CLASSIFICATION CODES

| 1 Gold | 2 Other Metals | 3 Diversified Resources | 4 Energy |
|---|---|--|---|
| 011 Gold Producer | 021 Diversified Mining | 031 Diversified Resources | 041 Oil/Gas Producer |
| 012 Gold Explorer | 022 Base Metals | 032 Oil, Steel, Mining | 042 Oil/Gas Explorer |
| 013 Gold, Other Mining | 023 Mineral Sands | 033 Mining, Smelting | 043 Oil/Gas Investor |
| 014 Gold, Oil | 024 Bauxite | 034 Fuels, Metals, Industry | 044 Gas Distribution |
| 015 Gold, Copper | 025 Diamonds | 035 Coal, Gold, Oil | 045 Coal |
| 016 Gold, Investment | 026 Mining (Producer) | 036 Oil, Gold, Investment | 046 Uranium |
| | 027 Mining (Explorer) | | 047 Other Energy Sources |
| | 028 Mining Investment | | |
| 5 Infrastructure & Utilities | 6 Developers & Contractors | 7 Building Materials | 8 Alcohol & Tobacco |
| 051 Tollway Operations | 061 Building, Contractor | 071 Building Materials | 081 Brewer |
| 052 Electricity, Gas | 062 Property, Development | 072 Cement | 082 Vintner |
| 053 Infrastructure | Manger | 073 Brick, Pipe, Tiles | 083 Tobacco |
| Investment | 063 Residential Developer | 074 Timber & Board | 084 Tobacco & Food |
| 054 Other Infrastrucure | 064 Developer, Retailer | 075 Concrete, Petrol | |
| 055 Other Utilities | 065 Developer, Finance | | |
| 9 Food & Household | 10 Chemicals | 11 Engineering | 12 Paper & Packaging |
| 091 Food | 101 Chemicals | 111 Heavy Engineering | 121 Packaging, Building |
| 092 Flour Miller, Baker | 102 Fertilisers | 112 Steel Merchants & | Materials |
| 093 Miller, Baker, Food | 103 Chemicals, Fertiliser, | Agents | 122 Forest Products, Trade |
| 094 Soft Drink/ Confectionery | Paint | 113 Machinery | 123 Forest Products, Paper |
| 095 Other Household Goods | 104 Industrial Gases | Manufacturer | 124 Paper Merchant |
| 096 Household Goods/ Chemicals | 105 Salt, Horticulture | 114 Engineering Contractor | 125 Can Manufacturer |
| | | 115 Light Engineering | 126 Plastic Bottles |
| | | 116 Aircraft | |
| 13 Retail | 14 Transport | 15 Media | 16 Banks & Finance |
| 131 Retail | 141 Transport | 151 Diversified Media | 161 Banking |
| 132 Wholesaler, Retail | 142 International Transport | 152 Publishers | 162 Finance Company |
| 133 Manufacturer, Retail | 143 Transport Other | 153 Television | |
| 134 Retail, Investments | Services | 154 Radio | |
| 135 Chemist, Investor | 144 Transport & Security | 155 Advertising, Marketing | |

| 17 | 18 | 19 | 20 |
|---------------------------------------|---------------------------------------|--|-----------------------------------|
| Insurance | Telecommunications | Investment & Financial Services | Property Trusts |
| 171 Insurance Company | 181 Network Operator | 191 Investment Trust/ Company | 201 Property Trust |
| 172 Insurance Broker | 182 Cables | 192 Equity Investor | 202 Property Trust & Developer |
| | 183 Equipment, Services | 193 Property Investor | |
| | 184 Other Telecommunications | 194 Trustee Company | |
| | | 195 Miscellaneous Financial Services | |
| | | 196 Investment, Food, Property | |
| 21 | 22 | 23 | 24 |
| Healthcare & Biotechnology | Miscellaneous Industrials | Diversified Industrials | Tourism & Leisure |
| 211 Pharmaceutical | 221 Miscellaneous Industrials | 231 Diversified Industrial | 241 Casinos/Gaming |
| 212 Biotechnology | | 232 Sugar, Building Material | 242 Hotel Operations |
| 213 Hospital Management | 222 Miscellaneous Services | 233 Forest Products, Building | 243 Leisure Activities |
| 214 Health & Medical Services | 223 Mining Services | 234 Electronics, Media | |
| 215 Health & Related Products | 224 Agriculture & Related Services | 235 Media, Textiles | |
| | 225 Automotive & Related Services | | |
| | 226 Computer & Office Services | | |
| | 227 Entrepreneurial Investors | | |
| | 228 High Technology | | |

APPENDIX 2 – AVERAGE NUMBER OF QUERIES PER COMPANY BY SECTOR

| | Sector | Average Number of Queries per Company |
|----|---------------------------------|--|
| 1 | Gold | 2.056 |
| 2 | Other Metals | 1.912 |
| 4 | Energy | 1.794 |
| 5 | Infrastructure & Utilities | 1.444 |
| 6 | Developers & Contractors | 1.500 |
| 7 | Building Materials | 1.000 |
| 8 | Alcohol & Tobacco | 1.333 |
| 9 | Food & Household | 1.500 |
| 10 | Chemicals | 1.000 |
| 11 | Engineering | 1.600 |
| 12 | Paper & Packaging | 1.000 |
| 13 | Retail | 1.308 |
| 14 | Transport | 2.000 |
| 15 | Media | 1.696 |
| 16 | Banks & Finance | 1.000 |
| 17 | Insurance | 1.750 |
| 18 | Telecommunications | 2.353 |
| 19 | Investment & Financial Services | 1.633 |
| 20 | Property Trusts | 1.000 |
| 21 | Healthcare & Biotechnology | 1.725 |
| 22 | Miscellaneous Industrials | 2.157 |
| 23 | Diversified Industrials | 1.000 |
| 24 | Tourism & Leisure | 1.333 |

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